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The Manufacturers Hanover
Economic Report

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Economic Forecast For 1984

As the U.S. economic recovery approaches its first birthday, it seems to be developing a fair amount of momentum. Initially powered by increased consumer spending on autos and housing, the pickup in economic activity has now spread to other industries. What is more, after two years of liquidation, businessmen are now adding to their inventories. This is giving a further lift to the demand for materials, workers, and productive machinery. The resulting rise in capacity utilization and lengthening of delivery times have prompted some corporations to dust off their capital spending plans, suggesting that the two-year decline in these outlays may also be drawing to a close.

Does this necessarily mean that the economy will continue to grow at the relatively fast rates of speed of the second and third quarters of 1983, thereby raising the possibility of a resurgence of inflation and higher interest rates? I do not think so. I believe that the rate of expansion of business activity will slow to a more sustainable pace during the fourth quarter of this year and in 1984 as it has at this point during most postwar economic recoveries.

Inventories Boost The Economy...

The gains in the real gross national product during the first half of 1983 were enhanced by business inventory policies. Stockpiles were liquidated at a massive $22.7 billion annual rate in the fourth quarter of 1982, slowing to a $15.4 billion liquidation pace in the first quarter of 1983, and then $5.4 billion in the second quarter. Thus, of the rise of $44 billion in the real GNP that took place between the fourth quarter of 1982 and the second quarter of 1983, $17.3 billion, or 39 percent did not represent a rise in output, but came from a slowing in the pace of inventory liquidation.

This kind of push from inventory policies is not likely to continue. For one thing, as the third quarter preliminary GNP figures already reveal, there was a shift from liquidation to accumulation of business inventories. Expanding inventories entail different business strategies, labor and financing needs than cutting inventories and while more and more businessmen are becoming optimistic about the future, I do not get the impression that they are ready to go all out and build inventories as fast as possible. For one thing, as noted in the June Economic Report, there are some deterrents this time around. These include a relatively low rate of inflation, extremely high real cost of money, and ready availability of goods because of today's still-low rate of capacity utilization and overvalued dollar. For another, there is still a sizable amount of caution that pervades corporate boardrooms. Businessmen remain concerned about the longer term outlook for interest rates, inflation, and economic growth and appear to be unwilling to make more than a modest commitment toward stockbuilding.

Whenever the ongoing recovery is evaluated, it always seems to be in terms of what it means for future inflation trends. This is understandable, in view of the escalation of inflation that occurred during most of the postwar era —especially since the mid-1960s. However, as readers of these Reports know by now, the progress made against inflation this time around is unprecedented in recent economic history. What is more, inflation is likely to stay subdued because of such factors as stable oil prices, only modestly higher commodities' prices, and a salubrious combination of small wage increases and hefty improvements in labor productivity.

Along with low rates of inflation have come slightly lower interest rates. Since August, rates on high quality corporate bonds have fallen by about half of one percentage point, while commercial paper rates are off by as much as one full point. Some of this no doubt traces to market factors such as the Federal Reserve's seeming ability to get the money supply to grow within its target bands. But some probably reflects the continued good news on inflation. Interest rates on both long- and short-term instruments should decline further in the months ahead as long as economic growth and inflation

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remain moderate and the Federal Reserve is able to keep the money supply under control. In turn, these lower interest rates will enable the recovery to continue.

Business financing patterns have also played a role in recent interest rate developments. For most of this year business has been paying down short-term debt with funds obtained in the bond or stock markets. This has made room for the Treasury to borrow in order to finance its huge budget deficit. With inventories now on the rise and most business balance sheets looking better, it may not be reasonable to expect this pattern of corporate finance to continue much longer.

... While Increased Consumer Spending ...

Looking at the rest of the economy, it would appear that the consumer remains in fine shape. Although the savings rate remains below normal, incomes are growing faster than prices, leading to gains in buying power enough to enable most people to lift their rates of spending. The upcoming Holiday buying season looks like the best in several years. Last year at this time the economy was touching the low point of the recession while the unemployment rate was rising to what ultimately was a postwar high. The year before, the unemployment rate had begun to climb as well and there was a feeling that hard times lay ahead. And while the unemployment rate was declining during second-half 1980, buying power was suffering at that time because of the huge rate of inflation. To prove the point, the discomfort index (the combination of inflation and unemployment) was a high 20 at this time three years ago; today it is less than 12.

As for what consumers will buy, expect continued interest in new homes and automobiles especially if interest rates drop a touch as is generally expected. Although only about one out of every four families can afford to buy the typical new home today, this is a lot better than the situation that prevailed two years ago when fewer than one out of every six was eligible. Automobiles finally seem to have found forward gear, thanks to relatively stable prices, along with improvements in appearance and quality. Needless to say, there are a whole host of other consumer items that promise to do well in the next few months—not the least of which are personal computers, video cassette recorders and other electronic items.

The business sector will remain mixed. As noted earlier, there does appear to be a trend toward a modest inventory buildup. In addition, businessmen seem to be spending on such capital goods as business computers, telecommunications, and smaller types of machinery for purposes of modernization. However, one does not get the impression that businessmen are ready to break loose and spend more on such major capital goods as factories, office buildings, shopping centers and the like. These may pick up at some point in 1984—especially as capacity utilization reaches and goes over 80 percent, but I would not look for much in the way of this type of spending for several reasons. First, as noted earlier, the cost of money especially in real terms remains high. Second, confidence over the longer term is still relatively fragile and these kinds of capital goods are certainly long-lived in nature.

One of the major negatives that still clouds the outlook deals with our foreign trade sector. The dollar may have come down a touch compared with other key currencies, but it is still overvalued in terms of purchasing power. This means that many goods produced in the United States are simply too expensive when sold

October, 1

MHT FORECAST OF GROSS
(Seasonally Adjusted
In $ Billi

	< Actual			Projected >	
	1983				Y
	I	II	III	IV	LE
Gross National Product	3171.5	3272.0	3363.3	3450.5	331
GNP: $72	1490.1	1525.1	1554.4	1573.6	153
% Change, Annual Rates	2.6	9.7	7.9	5.0	
Consumption	2073.0	2147.0	2186.5	2238.6	216
Durables	258.5	277.7	284.2	296.5	27
Non-Durables	777.1	799.6	818.7	834.5	80
Services	1037.4	1069.7	1083.5	1107.7	107
Investment	404.1	450.1	501.0	521.7	46
Non-Residential	332.1	336.3	348.4	357.9	34
Producers Durable Equipment	199.3	208.8	217.9	224.8	21
Structures	132.9	127.4	130.5	133.1	13
Residential	111.3	128.4	140.7	140.6	13
Inventory Changes	−39.4	−14.5	11.8	23.2	−
Net Exports	17.0	−8.5	−25.9	−22.3	−
Government Purchases	677.4	683.4	701.8	712.5	69
Federal Defense	194.4	199.4	205.8	214.7	20
Federal Civilian	79.1	74.3	75.4	68.7	7
State & Local	404.0	409.7	420.6	429.1	41
Final Sales: $72	1505.5	1530.5	1549.6	1563.8	153
% Change, Annual Rates	0.6	6.8	5.1	3.7	
GNP Price Index (1972 = 100)	212.8	214.6	216.4	219.3	21
% Change, Annual Rates	5.5	3.3	3.4	5.5	
PCE Deflator (1972 = 100)	210.1	212.5	214.5	217.1	21
% Change, Annual Rates	2.1	4.6	3.8	5.0	
Consumer Price Index (1967 = 100)	293.5	296.6	300.0	304.3	29
% Change, Annual Rates	−0.4	4.2	4.8	5.8	
Total Personal Income	2657.8	2713.6	2761.4	2831.6	274
Disposable Personal Income	2255.9	2301.0	2361.5	2419.7	233
Savings Rate	5.4	4.6	4.7	4.8	
Employment Rate	55.6	55.9	56.7	57.2	5
Unemployment Rate	10.4	10.1	9.4	8.9	
Indus. Production (1967 = 100)	138.5	144.5	151.6	156.6	14
Housing Starts (000)	1694.3	1683.0	1788.3	1610.1	169
Domestic Auto Sales (000)	6066.7	6933.3	6947.7	7535.7	687
Corporate Pre-Tax Profits	169.7	203.3	225.3	237.0	20
− Taxes	61.5	76.0	81.1	88.0	7
Net Profits	108.2	127.2	144.2	149.0	13
− Dividend Payments	71.4	72.0	73.7	76.0	7
Undistributed Profits	36.7	55.2	70.5	73.0	5
+ Depreciation	242.2	255.4	270.7	277.1	26
− Inventory Profits	1.7	10.6	15.1	18.5	1
Net Cash Flow	277.2	300.0	326.1	331.6	30

abroad, and by the same token, goods produced overseas are very cheap when sold in the United States. Over the past two years, the decline in net exports has lopped $31 billion off the real gross national product. This may not seem like much in a $1.5 trillion (real terms) economy until you realize that the third quarter 1983's real GNP was only $28 billion higher than in third-quarter 1981. If net exports had remained unchanged over this period, third-quarter 1983's real GNP would have been $59 billion above its level of two years ago and the recession would not have been as severe as it was.

... Offsets Weakness Elsewhere

Other sectors that appear to be lagging behind the economy include what is commonly known as Smokestack America, the Farm Belt, and the Oil Patch. The smokestack industries (steel, coal, copper and the like) will enjoy better times in 1984, but nowhere near a boom. This is because of the changing needs of the market place. To the extent that people are buying more automobiles and houses, they are buying smaller ones, which in some cases either imported from abroad or made with materials imported from abroad. Additionally, as noted earlier, big-ticket capital spending is not likely to pick up rapidly, further depressing the demand for steel and other building materials.

The agricultural sector will also do better in 1984 than in 1983 but, as always, is subject to the vagaries of the weather and politics. Washington's Payment In Kind program helped some farmers but not all. And some farmers benefited from the effects of the weather but others suffered. However, the combination of steady labor and oil costs should provide a lift for this important sector. As for the Oil Patch, it is in difficulty now mainly because of the expectations of some investors, bankers, and others that oil prices would climb to the sky. It must be remembered that the present level of oil prices is roughly ten times what it was ten years ago. A growing economy in the U.S. and worldwide should gradually increase the demand for oil—although obviously not in the same proportion as was the case in earlier recoveries, when the conservation ethic was not as strong.

All in all, it appears as though the current economic expansion still has some time left before difficulties pop up. As you can see from the table, we are expecting the economy as measured by the real GNP to grow in every quarter in 1984—albeit at different rates of speed. The unemployment rate should fall irregularly to the eight percent zone by this time next year while inflation will remain relatively moderate. Corporate profits are likely to climb 25 percent next year on top of a 20 percent increase in 1983. New home construction looks like it will hold at today's levels but sales of domestic automobiles are likely to climb further. The fact that 1984 is an election year should serve to bolster confidence since more times than not; the economy has grown in years divisible by four.

Trees do not grow to the sky and economic expansions do not last forever, However, a couple of statistical items are worth noting. The current expansion is now about as old as the 1980-81 upswing. That one ended prematurely, since in all of our business cycle history only two other expansions were anywhere near as short and you have to go back more than 60 years to find them. The average postwar peacetime recovery has lasted three years; including periods of war nearly four years. You can see where, from a historical standpoint, the current expansion would seem to have many more months of life left.

83
NATIONAL PRODUCT
Annual Rates)
s

AR 1983		1984				YEAR 1984	
L	% CH	I	II	III	IV	LEVEL	% CH
3	7.9	3525.0	3601.9	3682.7	3770.6	3645.1	10.0
8	3.4	1588.6	1605.2	1622.8	1641.8	1614.6	5.1
4		3.9	4.2	4.5	4.8	5.1	
3	8.5	2277.9	2321.6	2364.7	2409.0	2343.3	8.4
3	14.2	299.8	307.4	315.4	323.6	311.5	11.6
5	6.1	847.4	859.8	871.4	883.8	865.6	7.2
6	8.9	1130.7	1154.4	1177.9	1201.7	1166.2	8.5
2	13.2	529.0	546.3	569.0	595.7	560.0	19.3
7	−1.3	367.3	377.4	388.0	399.1	382.9	[illegible]
7	3.0	230.8	237.0	243.3	250.0	240.3	13.0
0	−7.7	136.5	140.4	144.7	149.1	142.7	8.9
3	43.5	142.1	144.1	150.3	156.2	148.2	13.8
7		19.6	24.8	30.7	40.4	28.9	
9		−17.9	−19.1	−21.6	−25.0	−20.9	
8	6.9	736.0	753.2	770.6	790.9	762.7	9.9
6	13.5	219.5	226.6	232.4	241.7	230.1	13.0
4	−6.2	78.8	80.8	83.0	84.8	81.9	10.1
9	6.5	437.7	445.8	455.1	464.4	450.7	8.4
4	2.9	1580.4	1595.0	1610.3	1625.6	1602.8	4.3
9		4.3	3.7	3.9	3.8	4.3	
8	4.3	221.9	224.4	226.9	229.7	225.7	4.6
3		4.9	4.6	4.6	4.9	4.6	
6	4.0	219.5	222.0	224.4	226.9	223.2	4.5
0		4.5	4.5	4.5	4.5	4.5	
6	3.3	307.8	311.4	315.0	318.6	313.2	4.9
3		4.7	4.8	4.7	4.7	4.9	
1	6.3	2885.9	2939.7	2998.0	3064.9	2972.1	8.4
5	7.3	2468.6	2513.1	2561.2	2616.0	2539.7	8.8
7		5.0	4.9	4.9	5.2	5.0	
3		57.5	57.8	58.0	58.3	57.9	
7		8.6	8.4	8.2	8.1	8.3	
3	6.6	158.7	160.2	162.0	164.3	161.3	9.2
9	60.0	1605.0	1691.4	1760.5	1743.0	1700.0	0.4
3	19.3	7734.0	7807.3	8082.5	8219.8	7960.9	15.9
9	19.9	248.6	253.5	264.1	278.6	261.2	25.1
7		93.4	95.3	100.1	106.9	98.9	
2	14.8	155.3	158.2	164.0	171.7	162.3	22.8
5	6.7	78.5	81.0	83.4	85.9	82.2	12.2
9	26.9	76.8	77.2	80.5	85.8	80.1	36.1
1		282.9	289.4	295.9	302.1	292.6	
5		18.0	16.4	17.7	19.6	17.9	
7	19.2	341.7	350.2	358.7	368.3	354.7	14.9

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Economic Report

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NOVEMBER 1983

Politics and Economics

November is always an interesting month. Weatherwise, it tells us in no uncertain terms that the balmy days of summer and fall are over and that winter is definitely on the way. Its holidays are unique as well: On Thanksgiving Day we assemble our families and close friends and give thanks for the blessings bestowed upon us; on Veterans Day we honor those who took part in battles to defend our country, while on Election Day we exercise our right to choose those who will lead us in the months and years ahead.

Since this was an "off-year" election, attention has begun to shift to November 1984 and the Presidential elections. The economy will no doubt be an issue in the upcoming campaigns—both past performance as well as the trend of the coming months. Besides these usual characteristics, 1983's November has another claim to fame: It marks the first anniversary of the present economic recovery. As you might expect, a number of economists and politicians are claiming responsibility for this improvement in economic activity. I think it might be useful to examine these claims to see just where the credit lies.

By and large, it is the Administration and its supply-side advisors who claim credit for the current improved state of economic affairs. Talking Points, a newsletter published by the Republican National Committee, said in a recent issue that the economic progress President Reagan promised is the economic recovery we are now enjoying: "The Reagan Administration has made tremendous progress in turning our economy around."

Promises, Promises

It seems to me that the way to determine who should take the credit for the current upswing is to compare the supply-siders' promises about the economy with its actual performance. First of all, the Administration and its economic supporters promised that the economy would begin to improve starting on the day after Election Day 1980 (if they won) because they had presented what they felt was a coherent program to reduce inflation and interest rates while stimulating economic growth. A small group within this cadre, who believed in a theory known as rational expectations, felt that if the Administration could convince people that things would be different than before, people would act in such a way as to cause these desired results to occur.

For example, tax cuts, which were an integral part of the Administration's program, are normally viewed as contributing to additional expenditures by those receiving the tax relief. If these cuts were to be considered as a means toward reducing inflation, the theory went, people would not spend more, they would save more, instead, to take advantage of high interest rates without fear that their dollars' buying power would be eroded. As for investors, they would shift their preferences from precious metals, real estate and other tangible assets to such financial assets as corporate bonds and Treasury securities, if they thought inflation was going to recede. This portfolio shift would increase the supply of funds available to the capital markets so that interest rates would not rise—even if the Federal Reserve maintained a very tight rein on money growth.

About the only part of this program that worked was the slowing of inflation—and it worked not so much because people believed that inflation would slow, but because the Federal Reserve tightened up, thus causing interest rates to rise and the amount of funds available for borrowing and spending to decline. This was no new economic policy, but the traditional means by which inflation had been slowed in the past. I might add that this emphasis on tight money was part and parcel of the Administration's program. Quoting from the President's State of the Union message in January 1981: "... Our plan requires a national monetary policy which does not allow money growth to increase consistently faster

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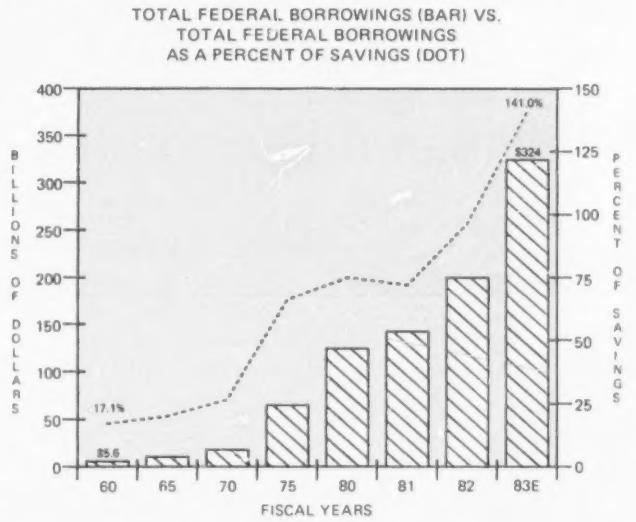
than the growth of goods and services. In order to curb inflation, we will need to slow the growth in our money supply."

After they were in office and the economy showed little signs of improvement, the Administration's economic team suggested that it would be the passage of what came to be known as the Kemp-Roth tax cut that would get the economy moving again. In March 1981, President Reagan declared that such a cut in taxes, when passed, would produce "an immediate impact on the economic vitality of the nation." As you well know by now, even as the bill became law in August 1981, the economy was slipping into one of the worst recessions of the postwar era.

The tax cut was supposed to do other things as well. It was billed as generating enough extra revenues to pay for an increase in defense spending and still balance the budget by fiscal year 1984. We got the increase in defense spending (and nondefense spending as well), since federal budget outlays went from 22.9 percent of GNP in 1980 to 25.6 percent in 1983, according to the Treasury Department. Unfortunately, we did not get the surge in revenues that the Administration expected. Receipts as a percent of GNP, reports the Treasury, were 20.1 percent in 1980—and only 18.6 percent in 1983. Nor are we likely to get these revenues in the foreseeable future. The Office of Management and Budget estimates that the Economic Recovery Tax Act of 1981, generating progressively larger annual losses in revenues, will cost the government $627 billion in tax revenues between 1982 and 1986. This is about four-fifths of the $785 billion cumulative deficit that the Administration now believes it will run during this time!

Needless to say, we do not have a balanced budget. Indeed, the budget deficit grew from $59.6 billion in 1980 to $110.6 billion in 1982 and in the fiscal year ended September 30, 1983 reached a whopping $195½ billion. Whether you look at this in terms of the deficit as a percentage of GNP, or, as we prefer to do, total Federal borrowing requirements compared with the amount of net savings available in the economy, it is clear that we are in uncharted territory. The financial markets have reacted to this by keeping interest rates high even though the rate of inflation slowed. They fear that either these deficits and their associated borrowing requirements would overwhelm the money and credit markets, driving up interest rates in the process —or that they would not; that the Federal Reserve would monetize these deficits, but in the process, set the stage for a new round of inflation.

Not surprisingly, in view of these high interest rates, another supply-side promise failed to come true. This was the positive impact on business investment that the tax cut was supposed to generate. Capital spending began falling immediately after the bill's enactment, leading to the first two-year decline in such outlays



since the end of World War II. And while capital spending is picking up now, most of the rise seems to be attributable to business spending on equipment for purposes of modernization to cut costs, rather than on such major capital goods as factories, office buildings, shopping centers and the like which would increase the capacity of industry to produce and compete more effectively with other countries.

Savings Are Down . . .

Another thing the supply-side program did not do was encourage savings. This has to be a major disappointment for these advocates, since a large part of the Administration's program was targeted on this objective. For example, the tax cuts were skewed toward the middle and upper income brackets. In addition, legislation was passed allowing the banks to offer All Savers certificates, which enabled people to earn a substantial amount of interest from a bank deposit free of Federal taxes. There was also an expansion of individual retirement accounts (IRAs) and Keogh plans which, it was thought, would further induce people to save. No doubt many people have taken advantage of these plans. However, most seemed to have done so—not by saving new money, but rather, by shifting savings from other accounts. From 6.6 percent annually in 1981, personal savings as a percent of take home pay fell to 5.8 percent in 1982, and to only four percent in the second quarter of 1983—the lowest quarterly rate in 33 years

—before rising to 4.7 percent in the third quarter. In the context of the Federal governments's borrowing needs which, as noted earlier, have grown tremendously, this reduced rate of savings obviously means less money available for others to tap such as home builders, small businessmen, and consumers who need to borrow in order to make major purchases.

On another note, supply-side economics has not caused people to abandon tax shelters. Although measuring tax shelter activity is difficult and there is no formal definition of just which of a vast array of tax-favored activities should be regarded as shelters, at least one measure, the public sale of investments registered as limited partnerships (which is how most tax shelters are sold) shows enormous growth. According to Robert A. Stanger and Company, a New Jersey firm that tracks the shelter industry, sales totalled $6.2 billion in the first three quarters of 1983—70 percent higher than the comparable period of 1982. Mr. Stanger predicts that Americans will put $12 billion into shelters this year, 50 percent more than last year.

If the supply-side program did not cause the economy to recover, what did, and what kind of upswing will it be? It seems to me that the turnaround was triggered by the sharp declines in interest rates that began in summer 1982. As the cost of money came down the stock market revived. In turn, this enabled many people to purchase new cars and new homes and because automobiles and residential construction are the nation's two key industries, their revival sparked an upturn in many other sectors, leading to today's improved business climate.

Naturally, the Federal Reserve was instrumental in bringing interest rates down. Abandoning its earlier policy of tight money and rigid concentration on the monetary aggregates which was a part of the Administration's original economic program, the Federal Reserve eased money in order to end the liquidity crisis that developed when tight money clashed with the mammoth budget deficits that resulted from the tax cuts.

To their credit, many of the supply-siders recognized fairly early that the mixture of tight money and a loose fiscal policy could only be a prescription for disaster and began recommending that the Federal Reserve change its policy. However, when pressed, they would not say that they were calling for the Federal Reserve to ease money, thus risking a new round of inflation. Rather, they disguised this by claiming that all they wanted the Federal Reserve to do was to "stabilize prices and exchange rates." When asked whether a relaxed grip on money by the Fed would cause more inflation, a prominent member of Congress said last year: "It isn't a question of relaxing the Fed's grip on money. It is not a question of looseness or tightness. It is a question of stabilizing the value, the quality, of the currency." Since he and others were looking at prices of gold and other commodities that were falling during this time, however, the net effect of their recommendation was the same: They wanted the Fed to be more liberal in providing funds to the economy.

. . . Interest Rates May Rise

Our economic recovery of today, therefore, exists not because of supply-side economics—but in spite of it. The upswing will last as long as the Federal Reserve is able to provide enough money to take care of the financing needs of the private sector in the wake of the continuing large demands for funds by the government without creating so much money and credit that a new round of inflation ensues. If the Federal Reserve means what it says when it indicates that it does not intend to allow a new round of inflation to develop, then it should be expected that some time in 1984 the needs of the private sector will clash with those of the public sector and interest rates will begin to climb.

At the moment, as I observed in the October Report, business borrowing requirements are fairly low. For most of this year business has been paying down short term debt with funds obtained in the bond or stock markets. In addition, the tremendous improvement in profitability has led to a surge in cash flow that appears to be more than equal to expenditure needs for operations, inventories and capital goods. Thus, the Treasury has room to borrow to finance its huge budget deficit without boosting interest rates. However, the funding out process, as this is called, will not last indefinitely and when it comes to a close, upward pressures on interest rates will resume unless the budget deficit is brought down quickly. Since the Administration and its economic supporters have lately tended to minimize the importance of budget deficits and their correlation with such factors as interest rates, and since attempts to introduce programs that would cut spending and raise tax revenues have constantly been defeated, it does not appear likely that the budget deficit will shrink appreciably over the near term.

If the supply-siders have any new ideas as to how Federal financing needs can be accomplished in a non-inflationary environment without crowding out the private sector, now is the time to make them public—not after the next elections. H

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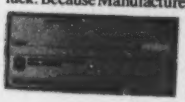

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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
Senior Vice President
and Economist

DECEMBER 1983

Anniversaries

Before 1983 draws to a close, it might be worthwhile to note that it marked the tenth anniversary of three economic developments which had a major and lasting impact on the U.S. and most of the rest of the world. Ten years ago we experienced our first modern round of widespread and persistent double-digit inflation. Nineteen hundred seventy three also marked the adoption of generalized floating foreign exchange rates. Last but not least, the first oil "shock" occurred in 1973, in which oil prices were increased dramatically and oil supplies restricted. Looking back, these three developments seem intertwined—and maybe they were, to some extent. Nevertheless, each had its own distinct origins, as well as its own separate impact on the United States and others. Finally, each carries with it its own lessons for the future.

Double-Digit Inflation

Both the U.S. and other economies were building up to double-digit inflation prior to 1973. All the major industrial countries entered simultaneously into an expansion in 1972. In the second half of that year, real GNP rose at an annual rate of six percent in the seven largest OECD countries (Canada, France, Germany, Italy, Japan the United Kingdom and, of course, the United States). The growth rate in these countries increased even further—to nearly nine percent—in the first half of 1973. Not surprisingly, the rapid increase in production among so many countries was accompanied by an unprecedented explosion in world prices of industrial raw materials. Excluding fuels, prices of non-food industrial materials rose 2.5 times between early 1972 and early 1974.

Foods were no slouch, either. In 1972 the Soviet Union reported an extremely poor grain crop. This caused the USSR to purchase an enormous quantity of American grain at remarkably low prices. Crop failures occurred in other countries, and even in the United States food and feed grain output fell in 1972. The volume of U.S. grain exports increased dramatically between 1971 and 1973, and, combined with 1972's poor harvest, resulted in a sharp drawdown of grain stocks. The export price of American wheat more than tripled while the price of corn more than doubled. The food situation was further aggravated by the mysterious but well-publicized disappearance of the anchovies, a key source of protein feed, from their usual location off the coast of Peru. The sizable reduction in the anchovy catch put upward price pressures on soybeans—an alternate source of protein. Compounding all of this was the fact that the grain deals with Russia tied up the nation's railroads and port facilities, thereby restricting the movement of other goods, leading to temporary shortages and rises in their prices.

Thus 1973 was marked by a steady escalation in the rate of inflation. Starting at about four percent at the turn of the year, the three-month rate of rise in consumer prices rose steadily, breaking through the double-digit barrier by October 1973, with an inflation pace of 12 percent. Looked at on a three-month basis, the rise in consumer prices remained at a double-digit annual rate until early 1975, when, in the wake of what was until then the worst recession of the postwar era, the rate of price increases began to slow. This lasted until early 1976. Then, with the recession a year behind them, both labor and management began to ask for and became more tolerant of higher wages and higher prices. Once again inflation crept steadily upward and by early 1979 it was back into double-digits, running at an even higher rate than in 1973-74. It took a change in Federal Reserve operating tactics, as well as the most severe recession in the postwar era by many criteria (Economic Report—September 1983) to knock inflation down for the count.

Thus, ten years after double-digit inflation first surfaced, the rate of inflation has slowed dramatically. In the U.S., prices in 1983 went up by the smallest annual percentage in over 15 years. The rise in other indus-

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trialized countries was the least in over ten years. However, fears of a new round of inflation die hard. People may not be buying precious metals, Persian rugs, art or real estate the way they did four years ago. But the level of interest rates compared with the current rate of inflation suggests that it will take more than just a year or two of slowing inflation to convince participants in the economic process that we have finally returned to an era of price stability.

Floating Foreign Exchange Rates

The foreign exchange markets were already in turmoil when the decision was made to adopt floating exchange rates in March 1973. The thinking at the time was that this would be temporary, allowing various built-up pressures to be vented, and then there would be a return to a regime of par values. However, the inflation that overtook the world economy during this time made such a return difficult. It was compounded by the jump in oil prices in 1973 and the worldwide recession that developed in its wake. By early 1976 the combination of these shocks and the elapse of time had reconciled even the most ardent exponents of "fixed but adjustable par values" to the acceptance of a system of floating exchange rates.

To be sure, floating exchange rates had their supporters, too. Proponents claimed that, first of all, currency speculation and the resulting international monetary crises would be dramatically reduced, since the actual exchange rate would be dictated by the markets—not by governments. Second, advocates of floating rates asserted that, as a byproduct, balance of payments problems would be ironed out. Finally, the combination of the two would contribute to exchange rate stability without government intervention. These claims clearly proved to be exaggerated—although not because of floating exchange rates, per se. For example, while monetary crises, such as were common in the closing days of fixed exchange rates, have largely been avoided, in their place has appeared day-to-day currency volatility, spawning persistent distortions in exchange rates, generating a mood of uncertainty that may have injured world trade and discouraged cross-border investment. This is because each country continued to pursue its own narrow economic policy objectives, thereby causing differences in the value of currencies. It is obvious that floating exchange rates have not been able to impose the necessary discipline on different countries to force them to coordinate their economic policies.

On the other hand, the ballooning balance of payments deficits of a number of countries cannot be entirely attributed to floating exchange rates. For when the oil crisis struck, it led to something never before seen on the international scene: the running of persistent and expanding deficits in the external payments balances of a growing number of countries, in response to higher oil bills. Not only would this have occurred in the absence of floating exchange rates, it probably would have caused any system of fixed exchange rates to break down, anyway.

If there is a flaw in the floating exchange rate system, it is the underlying assumption that the markets will value currencies in such a way as to equalize terms of trade between most countries. In other words—even making allowances for different economic policies which result in different rates of inflation, floating exchange rates should take these into account and revalue or devalue currencies against one another in order that some semblance of equilibrium in trade can be maintained. In reality, this did not occur—at least insofar as it pertains to the dollar.

As you know, recent movements of the dollar seem to trace largely to interest rates, which are higher in the U.S., adjusting for inflation, than in virtually any other country. These high U.S. interest rates, relative to foreign rates, increase the demand for dollar assets, which, in turn, drives up the dollar exchange rate. In turn, this cuts into the ability of U.S. businessmen to sell goods overseas while enhancing prospects for the sale of imported merchandise here. Money flows out of the United States in response to the ensuing trade deficit—but returns, attracted by interest rate differentials.

Another problem not anticipated by advocates of floating exchange rates is the apparent inability of prices of imported merchandise to reflect changes in exchange rates. This is not to say that when the dollar fell, prices of imported merchandise were not marked up: they were. However, it seems that for many imported consumer goods sold in the United States, prices do not fall when the exchange rate of their country of origin declines. Since the end of 1980, the dollar has advanced by over 40 percent on a trade-weighted basis, yet import prices have fallen by only five percent. Part of this, of course, reflects higher prices abroad—but most seems to trace to an unwillingness of manufacturers, wholesalers, and retailers to reflect the lower exchange rates in U.S. selling prices.

To avoid creating further distortions, several steps should be taken. First, the United States must reduce its level of inflation-adjusted interest rates compared with other countries. The way to do this is through policies that will lead to a marked reduction in the

budget deficit, since it is fears of the impact of huge deficits that are causing the markets to keep real interest rates so high. Second, there needs to be a coordination of economic policies among the major trading partners of the Free World. Only in this way, can we establish the fundamentals for dampening swings in currency values.

If these two recommendations are implemented, we might consider some modification of the floating exchange rate system. Initially central banks could dip their toes in the water by intervening to dampen daily and weekly movements in exchange values. Ultimately, we might be able to move toward a new system that provides both stability and flexibility. Whether it is fixed but adjustable exchange rates, or floating rates with target zones is not important. What does matter is that the international monetary system do a better job of valuing currencies, promoting trade and capital flows than it is doing now.

The Oil Shock

A lot has been written about the price and availability of oil in the past ten years—not surprising, in view of the tenfold price increase that has occurred during this time. A lot has been blamed on the jump in oil prices—including double-digit rates of inflation and interest and the two worst recessions since the Great Depression of the 1930s. The rapid runup in the price of oil forced radical changes in the way Americans live and the way business operates, changing fortunes of whole industries and entire regions. Products or areas that were heavy users of energy fell into disfavor while those that used less energy or promoted energy conservation rose to the top.

Meanwhile, the financial markets were turned upside down. First there was the biggest outflow of money in history to pay for higher priced oil, then the biggest inflow as the Organization of Petroleum Exporting Countries (OPEC) sent these funds into U.S. banks, then the biggest lending program in history as the banks "recycled" these OPEC deposits to those consumers, companies, and countries who were faced with a sudden need to pay higher oil bills.

Starting in 1973, and continuing through the early part of this decade, each meeting of the OPEC countries was monitored nervously by the consuming countries to see what increase in price and/or cutback in output would result next. Conservation got underway as consumers, business and governments sought to reduce their dependence on imported oil in particular and energy in general. In response to the second oil shock of 1978-79, President Carter in June 1979, initiated the phase-out of crude oil price controls—a process completed by President Reagan in January 1981. The turnaround in the nation's energy situation since then has been nothing short of dramatic. From a level in spot markets exceeding $42 per barrel in 1980 and early 1981, oil prices subsequently tumbled more than $14, ultimately forcing OPEC to announce the first price reduction in its history. And the question on everyone's mind as the oil ministers met recently in Geneva was not whether they would raise oil prices—but whether they could hold them at present levels or if they would have to announce another decline.

Besides price-induced conservation, decontrol of U.S. oil prices has resulted in a stabilization of U.S. crude oil production in the lower 48 states since 1980, after it fell nonstop during the previous nine years. Thanks to smaller, more fuel-efficient automobiles, better home insulation and extensive capital investments by business in energy-saving equipment, the relationship between energy use and economic growth has been significantly altered over these past ten years. For a solid half-century prior to 1973, each one percent growth in GNP required a one percent increase in energy. Since then, that ratio has fallen to about one to six—meaning that each one percent rise in energy consumption can now support a six percent rise in GNP.

Not suprisingly, we are using less petroleum today than we did ten years ago. Indeed, the industrial world is using less oil today than in the deep recession year of 1975. What is more, no matter what happens to the price of oil from here on out, these trends are unlikely to be reversed. This is because of several factors. For one thing, the automakers must manufacture cars which are much more fuel efficient today than their predecessors of 1973. By law, the corporate average fuel economy for each manufacturer's fleet sold in the U.S. in 1984 must be 27 miles per gallon. There was no such requirement in 1973; the average new car did well if it got ten miles per gallon in that year. Since 1973, many buildings have either been constructed or retrofitted with energy efficiency uppermost in mind; these will not be abandoned if oil prices go lower. Neither will homeowners rip out their insulation or remove their energy-saving thermostats should oil prices fall significantly. About the only thing that might happen if oil prices were to drop further would be that the switch to other sources of energy might slow.

With their share of market nearly cut in two, the OPEC nations have taught the world—and themselves—one important lesson: the law of supply and demand still works. H

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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
Senior Vice President
and Economist

JANUARY 1984

The Deficit

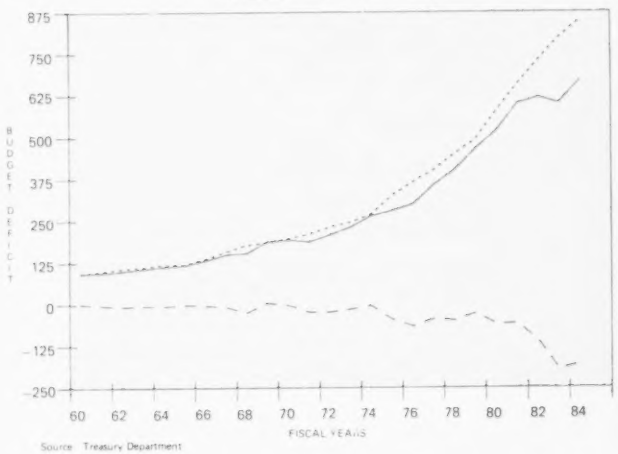
The Federal government's budget deficit is getting to be like the weather: everybody talks about it, but nobody does anything about it. The debate will surely intensify over the next few months, as Congress, business, the press, and economists react to the Administration's budget proposals for the next few years, which project a string of mega-deficits as far as the eye can see. Most economists, myself included, are extremely concerned about this. But this is where the unanimity ends. There is a division of opinion over why the deficit got so large, and what needs to be done to bring it down. There is also uncertainty as to when the current and projected deficits will begin to adversely affect the economy.

Why It Grew

The first thing that readers should be aware of is that, at the Federal level, annual budget deficits are nothing new. In the postwar era, Washington has run four deficits for each budget surplus; in the past quarter of a century there were only two years in which the budget was not in deficit. Yet, the economy managed to grow and prosper throughout this era because these deficits were relatively small, compared with the size of the economy, the financial markets, savings and so forth.

All this changed starting in 1981. It was then that the Economic Recovery Tax Act (ERTA) was passed. It called for an across-the-board reduction in individual income tax rates and other reductions in individual income taxes; the annual adjustment of the zero bracket amount, the personal exemption, and individual income tax brackets for inflation beginning in 1985; and the accelerated cost recovery of capital expenditures. As you can see from Chart I, government revenues, which had tracked expenditures fairly closely over the years, fell away starting in fiscal 1982, immediately upon passage of ERTA. No only did this widen the budget deficit for fiscal 1982 and 1983, it caused deficits projected for the future to remain large, thereby setting up the present budget quandary.

CHART I
FEDERAL BUDGET RECEIPTS (LINE), OUTLAYS (DOT)
AND BUDGET SURPLUS OR DEFICIT (DASH)
<BILLIONS OF DOLLARS>



Source: Treasury Department

As you know, the tax cut was supposed to eventually increase revenues to help close the budget gap. Instead, the tax cut widened it: The Office of Management and Budget estimates that ERTA, generating progressively larger annual losses in revenues, will cost the government $627 billion in tax revenues between 1982 and 1986. This is about four-fifths of the $785 billion cumulative deficit that the Administration now believes it will run during this time.

In one sense the President kept his promise when he said he would reduce the burden of government on the economy, since receipts as a percent of GNP were 18.6 percent in 1983—down from 20.1 percent in 1980. In another sense, however, his promise was not kept since Federal spending went from 22.4 percent of the GNP in 1980 to 24.7 percent in 1983. And the true burden of government in our economy is measured by spending—not by how it is financed.

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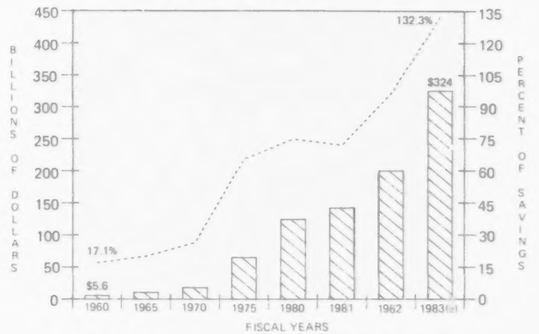
To sum it up, then, politicians have always had a tendency to spend money faster than the government was taking it in. And since the economy did not seem to suffer—indeed, at times it benefited from increased Federal spending and budget deficits—there didn't seem to be any reason to change things. So in one sense, the current deficit is a byproduct of a long-standing political process, which generated ever-increasing amounts of spending just a step or two ahead of revenues. However, the larger part of the current and projected future budget deficit traces to the tax cut program of 1981 which stunted the growth in revenues instead of accelerating it, as the Administration thought would be the case.

What It Means

To fully assess the impact of the budget deficit on the economy, it is necessary to separate the past and present from the future. The budget deficits posted in 1983 and the early part of 1984 undoubtedly had a positive impact on the economy while those projected for the latter part of this year and for 1985 and beyond would appear to have adverse consequences. The positive effects on the economy in 1983 were traditional in nature: Lower Federal taxes meant higher after-tax incomes for consumers and business. When combined with easier money and lower interest rates, this resulted in the burst of consumer spending that was responsible for getting the current economic recovery underway. Of course, the recovery was not as strong as it might have been, since interest rates adjusted for inflation remained above historical norms because the markets feared the financial consequences of these huge deficits. This limited the number of people who could buy such big-ticket items as a new car and a new house. It also constrained businessmen's willingness to invest in capital goods. And, of course, by raising the value of the dollar far above its economic worth, it cut into exports while encouraging imports.

If the deficits projected for the second half of 1984 and for 1985 were sharply lower than the deficit for 1983, these restraints on economic recovery would probably diminish and the economy would continue to expand. However, the deficits are not expected to decline significantly. What is more, most projections—including the government's—estimate that Federal budget deficits will remain close to present levels for many years into the future. It is at this point that the negatives of the deficit begin to outweigh the positives. The credit sensitive sectors will continue to lag behind the rest of the economy as will export industries and those that compete with goods imported from abroad. Interest rates will have to go higher in both nominal and real terms in order for private borrowing to decline enough to make room for increased government borrowing. One wonders how much further this process can go: As you can see from Chart II, the government in 1983 borrowed an amount equivalent to over 130 percent of the net savings generated in that year, up from only 17 percent in 1960.

CHART II
TOTAL FEDERAL BORROWING (BAR) VS.
TOTAL FEDERAL BORROWING
AS A PERCENT OF SAVINGS (DOT)



Source: Office of Management and Budget; Bureau of Economic Analysis

If crowding out isn't enough to worry about, how about uncontrollability? The longer we wait to cut the deficit, the more difficult it becomes to do so. This is because of the skyrocketing cost of servicing the debt. The national debt and interest on that debt are now rising faster than the gross national product. In 1980 the national debt was $914 billion, or about 35 percent of the GNP. By 1983 it had surged to $1.4 trillion, or 43 percent of GNP—and OMB predicts that by 1986 the national debt could amount to $2 trillion or nearly half of GNP (Chart III).

Now there has been a lot of talk about what is controllable and what isn't controllable when it comes to government spending. In reality, there is only one uncontrollable government expense: Interest cost. Given enough time and willpower, the government can cut any other expenditure—but it must meet its debt-service payments or face default.

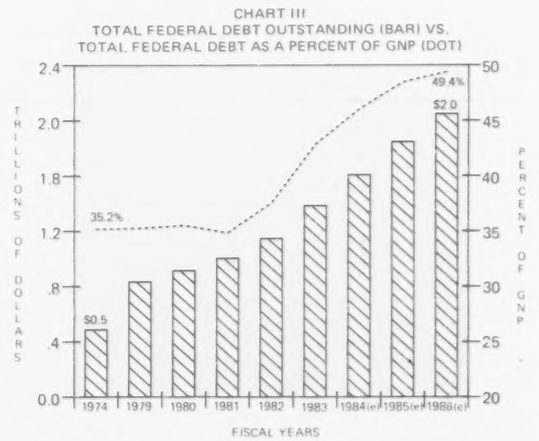
Here's where a major problem looms. Unless interest rates fall sharply or the budget is balanced swiftly, interest costs on the national debt will continue to rise. This is because a growing debt means that more securities will have to be issued. OMB predicts that by by 1988, annual interest costs will total more than $150 billion, 13½ percent of expected spending levels—and almost double that year's projected deficit!

How To Cut It

Like the impact of the deficit on the economy referred to above, cutting the deficit must be viewed in two ways. The deficit is such a critical problem that it must be attacked immediately—notwithstanding the fact that this is a Presidential election year. This suggests a short run approach. By the same token, since the deficits, themselves, did not materialize suddenly but have been part of the scene for decades, another approach should also be implemented, although its effects might not be felt for a longer period of time.

In case you haven't figured it out, the short run approach must be to raise taxes. Since fiscal 1984 is already one-third over, it will be difficult—if not impossible—to cut spending enough in the current fiscal year to make more than a tiny dent in the budget deficit. What is more, given the composition of Federal spending, it may be just as tough to cut outlays scheduled for fiscal 1985 as well: Military and international spending make up over 30 percent of the budget, spending on such entitlement programs as Social Security, Medicare and farm price supports accounts for 50 percent, while net interest on the national debt constitutes 12 percent for a total of over 90 percent. The remaining outlays, including grants to states and local governments amount to nearly $70 billion, or less than 40 percent of the current budget deficit. Thus, even if they were cut out entirely, we would still be left with a deficit of well over $100 billion.

CHART III
TOTAL FEDERAL DEBT OUTSTANDING (BAR) VS.
TOTAL FEDERAL DEBT AS A PERCENT OF GNP (DOT)



Source: Office of Management and Budget

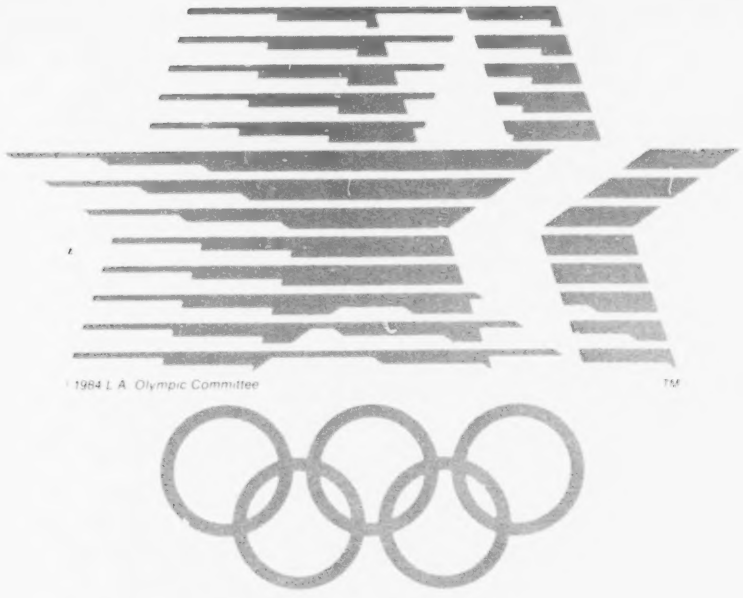
On the other hand, there is probably a lot that could be cut from government spending. The President's Private Sector Survey on Cost Control recently suggested that Washington could save nearly $425 billion over the next three years if it adopted some 2,500 recommendations to eliminate waste, reduce Federal retirement benefits, and, in general, put Federal operations on a more businesslike footing. And while most of the panel's recommendations to save money would require the assent of Congress, whose lawmakers have refused in the past to approve such proposals, about 27 percent, or $115 billion worth of cost reductions could be achieved through administrative action. If this panel is on track, and there is every reason to believe it is, then government spending can be reduced without weakening our defense posture and without cutting into necessary social welfare programs.

However, these recommendations cannot be achieved overnight. Of necessity, they must be considered long run—albeit vitally important—in nature. But the mounting size of the Federal debt and its accompanying interest costs suggest that immediate steps must be taken. Not only will shrinking the deficit today be easier than doing it tomorrow, but it will also ensure that the economic recovery will have a chance of surviving beyond 1984. As the May 1983 Economic Report said: "Government spending ought to be curtailed, to be sure—but government revenues must be restored in the meantime."

Conclusions

The bottom line to this discussion is simple. While the economy has been able to survive deficits in the past, it has never before encountered ones of today's magnitudes relative to the economy without significant side effects. There is no need to hunt for the villain in this deficit scenario—everyone deserves a share of the blame. Responsibility for today's deficits lies with the Congress, this and previous Administrations—and the American people who have continually asked for more from Washington than they were willing to ante up in the form of taxes.

What matters at this point is that the deficit must be tackled immediately, if not sooner. Today's deficit may be boosting economic activity but tomorrow's will surely curtail it. Cutting the deficit quickly may be hard, but waiting until after the elections will not make the job any easier. H



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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
Senior Vice President
and Economist

FEBRUARY 1984

Business Conditions Update

Ordinarily, this would be a time for cheer. The U.S. economy is barely into its second year of economic recovery, and history shows that, on average, postwar business expansions have lasted around three years during peacetime; four years including periods of war. This is a Presidential election year, and the economy has usually done well during these periods of increased political activity. More specific to the current expansion, consumers, business, as well as the banking system have rebuilt liquidity, suggesting that money is available to be spent. Inflation has moderated, meaning that dollars can go further, and while the unemployment rate remains uncomfortably high, the employment rate is well above its postwar average, reflecting a record number of people at work.

Yet, a feeling of unease seems to be developing. The stock market fell almost nonstop earlier this year as investors, transfixed by the Federal government's mammoth budget deficits and the Federal Reserve's unwillingness to ease its grip on the money and credit aggregates, came to the conclusion that no near-term decline in interest rates was likely. Rather, the opposite appeared to be the case: Interest rates seemed likely to rise, especially if business loan demand picks up, as it usually does both at this time of year and at this stage in an economic recovery. To the stock market, rising interest rates are anathema, since they represent not only competition in terms of immediate rates of return available on debt instruments, but they also suggest that business profitability may soon slow owing to rising costs of borrowing money, and a reduced rate of sales. And since many individuals and businesses rely on the stock market to generate wealth, hence buying power, not to mention as a measure of confidence, a deep enough fall in stock prices (this one has already shaved some $150 billion from household net worth) could bring on a contraction in economic activity—sort of a self-fulfilling prophecy.

While the stock market is a leading indicator of business activity it is not an infallible one. Every recession in the postwar era has followed a drop in stock prices—but not every drop in stock prices has been the forerunner of a recession. In other words—many traders and investors tend to overact to economic, financial and political developments. This may be one of these times, because when one moves away from Wall Street to Main Street, the scene brightens considerably.

Domino Theory

For over 60 years, every economic expansion but one lasted at least 21 months. There must be a reason for this. And the reason, as I see it, is that once a recovery gets underway, it develops a certain momentum not unlike a series of dominoes, which will fall one after the other once the first is pushed. The current expansion appears to be no different than the majority. The drop in interest rates that began in the middle of 1982 sent the stock market soaring and consumers flocking into showrooms to buy new cars and to lots to buy new houses. As these two industries recovered, they provided increased demand, not only for employees who produce these goods, but for the supplier industries as well. The entire consumer sector soon blossomed out and was a feature of the first year of recovery in 1983.

CIVILIAN EMPLOYMENT: CURRENT RECOVERY (LINE)
VS. AVERAGE OF PRIOR 7 RECOVERIES (DOT)
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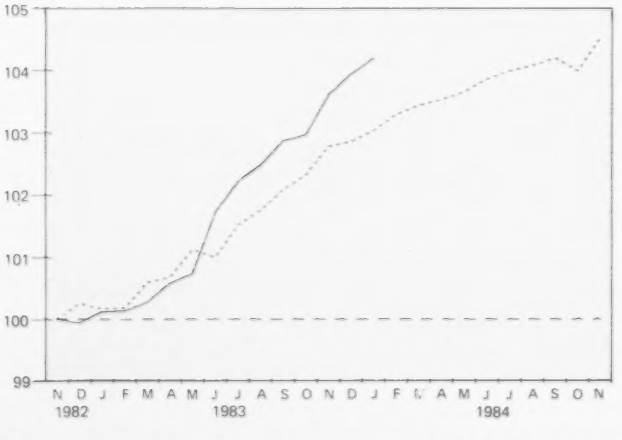

The consumer still has plenty of power left. Not only has the unemployment rate fallen faster than at any time in 30 years, but nearly 4¼ million jobs have been

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added so far in the current economic recovery. As you can see from the chart on page one, this represents an increase of 4¼ percent from employment levels prevailing at the end of the last recession; at this stage in the seven previous postwar recoveries, the rise in civilian employment was only about three percent, on average. To make matters even more interesting, hours worked have increased twice as fast as they usually do at this point in a business expansion.

These increased hours have fattened the wallets and boosted the morale of many people. The wages and salaries component of personal incomes increased nearly 8½ percent in 1983 compared with just four percent a year earlier. When you combine this with a consumer price inflation rate that was as low in the 12 months ending December 1983 as it was in the comparable period of 1982, you can see why consumers' confidence in January soared to its highest level in five years.

This alone should be enough to assuage fears for the business expansion. Consumer spending, as you know, accounts for two out of every three dollars that make up our gross national product. As long as employment and hours worked are rising and inflation remains low, people will find their buying power increasing, thus their willingness to spend growing as well. And there certainly would seem to be a lot of unfulfilled demands. Take automobiles, for example. While the annual selling rate of new domestic cars in January topped eight million units, this is still below levels first reached 11 years ago, when the population was much smaller. The average car on the road today continues to get older, and at 7¼ years of age, is the oldest since 1950. With spring on the way and many of Detroit's cars new in style or concept, don't overlook the possibility that auto sales will surge in the months ahead—giving another fillip to economic activity.

Housing is another sector that could be in for a pleasant surprise. Although the level of housing starts reached 1.9 million in January, it is still more than a half million units below levels first reached in 1972—when the number of people in the 25-34 year age bracket, the peak homebuying group, was one-third smaller than today.

To be sure, mortgage interest rates are still high. After having fallen to about 12½ percent last spring, they have since ticked upward to around 13½ percent, nationwide. However, this is a misleading average, since it is for a so-called conventional, fixed-rate loan, and most mortgage loans are now being made on a variable rate basis with interest rates during the first year or so far below that of the fixed-rate loan. These "creative" mortgages, combined with concessions from builders, are helping an increasing number of people buy homes who otherwise would not be able to. Needless to say, if housing strengthens further, so will the supplier industries, as well as the market for home furnishings.

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Business Adds Strength ...

While consumers continue to spend in the second year of an economic recovery, much of the incremental strength is derived from the business sector. The present expansion finds the business sector making a contribution. Spending on inventories is growing, in contrast to the liquidation that characterized the first half of 1983. The change from liquidation to accumulation added nearly 50 percent to the economy's growth rate in the second half of 1983. Further gains are likely, since even this turnaround in inventory building has not been enough to keep pace with rising sales. The ratio of inventories to sales in manufacturing and trade is now at its lowest point in the postwar era. Obviously this spells shortages in many lines, so it would not be unreasonable to expect some modest step-up in the rate of inventory building in the next few months.

Business is also spending heavily on capital goods. Since midyear 1983, expenditures on business structures have risen at more than an 11 percent annual rate, after having fallen nonstop during the six previous calendar quarters by $18 billion, or eight percent at annual rates. But the big jump has come in business equipment. Outlays for these items, which include computers, word processors, telecommunications facilities and the like, jumped by 19 percent from fourth-quarter 1982 to fourth-quarter 1983, paced by a rise at an annual rate of 27 percent in the second half of last year.

February, 1984
MHT FORECAST OF GROSS NATIONAL PRODUCT
(Seasonally Adjusted Annual Rates)
In $ Billions

	< Actual						Projected >					
	1983				YEAR 1983		1984				YEAR 1984	
	1	2	3	4	LEVEL	% CH	1	2	3	4	LEVEL	% CH
Gross National Product	3171.5	3272.0	3362.2	3432.0	**3309.4**	**7.7**	3519.4	3592.1	3664.5	3739.1	**3628.8**	**9.6**
GNP: $72	1490.1	1525.1	1553.4	1570.5	**1534.8**	**3.3**	1590.5	1607.2	1622.6	1636.6	**1614.2**	**5.2**
% Change, Annual Rates	2.6	9.7	7.6	4.5	**3.3**		5.2	4.3	3.9	3.5	**5.2**	
Consumption	2073.0	2147.0	2181.1	2233.1	**2158.6**	**8.4**	2270.4	2315.7	2360.5	2402.1	**2337.2**	**8.3**
Durables	258.5	277.7	282.8	295.2	**278.6**	**14.0**	299.9	309.2	317.9	324.1	**312.8**	**12.3**
Non-Durables	777.1	799.6	814.8	825.9	**804.3**	**5.7**	837.5	850.9	863.8	875.9	**857.0**	**6.6**
Services	1037.4	1069.7	1083.5	1112.0	**1075.7**	**9.0**	1133.0	1155.6	1178.8	1202.1	**1167.4**	**8.5**
Investment	404.1	450.1	501.1	529.8	**471.3**	**13.7**	555.7	560.3	574.3	590.0	**570.1**	**21.0**
Non-Residential	332.1	336.3	351.0	371.2	**347.7**	**0.2**	377.8	386.9	396.7	406.6	**392.0**	**12.8**
Producers Durable Equipment	199.3	208.8	220.2	236.8	**216.3**	**4.8**	240.8	246.1	252.0	258.0	**249.2**	**15.2**
Structures	132.9	127.4	130.9	134.5	**131.4**	**-7.4**	137.0	140.8	144.7	148.6	**142.8**	**8.7**
Residential	111.3	128.4	141.5	140.8	**130.5**	**43.8**	146.1	149.1	152.1	153.8	**150.3**	**15.1**
Inventory Changes	-39.4	-14.5	8.5	17.7	**-6.9**		31.9	24.3	25.6	29.5	**27.8**	
Net Exports	17.0	-8.5	-18.3	-32.6	**10.6**		-25.5	-29.4	-32.2	-35.2	**-30.6**	
Government Purchases	677.4	683.4	698.3	701.7	**690.2**	**6.3**	718.7	745.4	761.9	782.2	**752.1**	**9.0**
Federal Defense	194.4	199.4	201.2	206.2	**200.3**	**11.6**	214.2	221.2	227.0	236.2	**224.6**	**12.1**
Federal Civilian	79.1	74.3	76.9	69.4	**74.9**	**-5.5**	70.8	80.9	82.0	84.0	**79.4**	**6.0**
State & Local	404.0	409.7	420.2	426.1	**415.0**	**6.3**	433.7	443.4	452.9	462.0	**448.0**	**8.0**
Final Sales: $72	1505.5	1530.5	1549.7	1563.0	**1537.2**	**2.8**	1577.1	1597.1	1612.0	1624.6	**1602.7**	**4.3**
% Change, Annual Rates	0.6	6.8	5.1	3.5	**2.8**		3.6	5.2	3.8	3.1	**4.3**	
GNP Price Index (1972 = 100)	212.8	214.6	216.4	218.5	**215.6**	**4.2**	221.3	223.5	225.8	228.5	**224.8**	**4.3**
% Change, Annual Rates	5.5	3.3	3.6	3.9	**4.2**		5.1	4.1	4.3	4.7	**4.3**	
PCE Deflator (1972 = 100)	210.1	212.5	214.7	216.3	**213.4**	**3.9**	218.4	220.6	222.9	225.3	**221.8**	**3.9**
% Change, Annual Rates	2.1	4.6	4.2	3.0	**3.9**		3.8	4.1	4.3	4.4	**3.9**	
Consumer Price Index (1967 = 100)	293.5	296.6	300.0	303.6	**298.4**	**3.2**	306.7	309.9	313.4	316.8	**311.7**	**4.4**
% Change, Annual Rates	-0.4	4.2	4.8	4.8	**3.2**		4.2	4.3	4.5	4.5	**4.4**	
Total Personal Income	2657.8	2713.6	2761.7	2834.2	**2741.8**	**6.3**	2892.1	2940.2	2993.7	3050.8	**2969.2**	**8.3**
Disposable Personal Income	2255.9	2301.0	2361.7	2423.6	**2335.5**	**7.3**	2471.4	2511.6	2555.9	2603.3	**2535.5**	**8.6**
Savings Rate	5.4	4.0	4.9	5.1	**4.9**		5.4	5.0	4.9	5.0	**5.1**	
Employment Rate	55.6	55.9	56.6	57.0	**56.3**		57.4	57.7	58.0	58.2	**57.8**	
Unemployment Rate	10.4	10.1	9.4	8.5	**9.6**		8.1	7.9	7.8	7.7	**7.9**	
Indus. Production (1967 = 100)	138.5	144.5	151.8	156.0	**147.7**	**6.5**	159.0	161.1	162.7	164.6	**161.9**	**9.6**
Housing Starts (000)	1694.3	1683.0	1790.7	1692.0	**1715.0**	**62.0**	1771.0	1802.2	1768.1	1738.0	**1769.8**	**3.2**
Domestic Auto Sales (000)	6066.7	6933.3	6947.7	7220.7	**6792.1**	**18.0**	7813.3	7952.2	7895.8	7986.3	**7911.9**	**16.5**
Corporate Pre-Tax Profits	169.7	203.3	229.1	224.2	**206.6**	**18.6**	230.6	242.3	250.6	258.6	**245.5**	**18.9**
- Taxes	61.5	76.0	84.9	83.0	**76.3**		85.6	90.7	94.0	97.3	**91.9**	
Net Profits	108.2	127.2	144.1	141.2	**130.2**	**13.1**	145.0	151.6	156.6	161.4	**153.6**	**18.0**
- Dividend Payments	71.4	72.0	73.7	75.9	**73.3**	**6.7**	78.3	80.6	82.9	85.1	**81.7**	**11.6**
Undistributed Profits	36.7	55.2	70.4	65.3	**56.9**	**22.7**	66.7	70.9	73.7	76.3	**71.9**	**26.4**
+ Depreciation	242.2	255.4	270.7	281.4	**262.4**		290.7	295.6	301.0	306.6	**298.5**	
- Inventory Profits	1.7	10.6	18.3	8.5	**9.8**		13.8	17.9	21.8	22.7	**19.1**	
Net Cash Flow	277.2	300.0	322.8	338.2	**309.6**	**19.5**	343.6	348.6	352.9	360.2	**351.3**	**13.5**

... But Not Everywhere

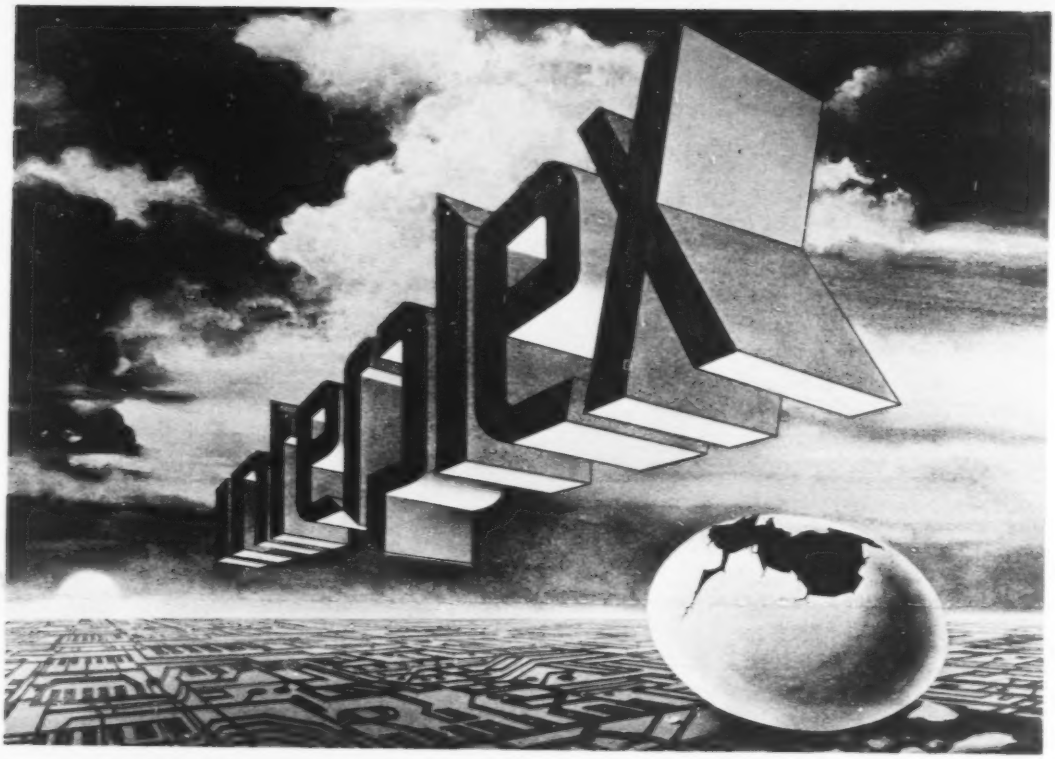
If there is a sector that is not making its normal contribution to economic growth it is foreign trade. Because the dollar remains overvalued compared with other key currencies, many goods produced in the United States are simply too expensive when sold abroad. By the same token, goods produced overseas are very cheap when sold in the United States. In 1983, the decline in net exports lopped nearly $21 billion off the real gross national product. This may not seem like much in a $1.6 trillion (real terms) economy until you realize that fourth-quarter 1983's real GNP was only $90 billion above the year before. If net exports had remained unchanged over this period, fourth-quarter 1983's real GNP would have been 7½ percent above its year-ago level, instead of the six percent rise it posted.

Looking at the overall private economy, therefore, it would appear that only the foreign trade sector is seriously dragging. However, if you consider the stimulus of increasing defense spending and the consistent growth in state and local outlays, it is hard to see how the stock market's fears can be justified. To be sure, it now appears that the combination of continued deficit spending by Washington and a relatively restrictive monetary policy does spell an increase in interest rates, at least in the shorter end of the maturity scale. But this alone should not justify a drop in stock prices.

The economy has demonstrated a remarkable ability to grow in the face of interest rates which, while down from their 1980-82 peaks, nonetheless are high by historical standards—especially in real terms. This should allay some fears regarding corporate profitability. Second, bond market interest rates, which, in the final analysis, are the real competitors with stock yields, are unlikely to rise significantly over the course of this year and may even hold steady. This is precisely because of the monetary policy noted above. By keeping a relatively tight rein on the supply of money and credit, the Federal Reserve is virtually ensuring that a new round of rapid inflation will not reappear in the foreseeable future. Since bond yields are also unusually high relative to inflation, it would seem that if inflation can be kept to the four-five percent range depicted in the table, there would be no reason for them to go up further.

Conclusion

Thus it would appear that the outlook for 1984 remains bright. If this is, indeed, the case, equity investors, as they have done many times in the past, may be worrying needlessly. Of course there is always the possibility that 1985 will be a poor year. With only two exceptions, we have had a recession in every post-Presidential election year since 1945. H



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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
Senior Vice President
and Economist

MARCH 1984

Is Inflation Imminent?

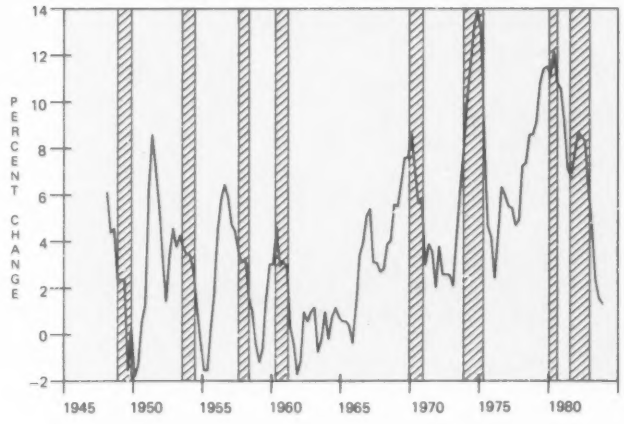
Nowadays, it is difficult to read about the current economic upswing without finding a growing amount of concern being expressed about inflation prospects. This is understandable. As we move further and further away from the 1981-82 recession, memories of its severity and its impact on price and wage decisions tend to fade. Additionally, the rate of inflation has ratcheted upward in every business cycle in over 30 years. Finally, several labor unions whose contracts expire this year are talking about big wage demands, some raw materials' prices seem to be heading up, and the dollar has taken a tumble in world currency markets.

In this profession, one learns, if nothing else, never to say "never." So I am not going to say that we will *never* see double-digit inflation again. However, I would suggest that we are not on the verge of double-digit inflation and are not likely to see double-digit rates of inflation anytime soon. I would define "anytime soon" as the rest of this year and a good part—if not all—of 1985. There are many reasons for this expectation, several of which I offer below.

Wages Rise More Slowly

First and foremost is the labor cost situation. The severe recession of 1981-82 continues to cast its shadow on current labor-management relations. The Labor Department tells us that major collective bargaining contracts settled in private industry last year yielded the lowest average wage adjustments in the history of this series. Wage adjustments under the contracts negotiated called for an average rise of 2.6 percent in the first year and 2.8 percent annually over their life. The last time the same parties bargained (two to three years ago, in most cases), average wage adjustments were 9.3 percent in the first contract year and 6.8 percent annually over the contract life. Additionally, one-fourth of these workers last year had their wages either frozen or decreased. A fairly widespread (if unusual) phenomenon during the recession, these wage "give-backs" are apparently continuing through the economic recovery. To make matters more interesting, they have spread to those companies and industries which are relatively profitable, as management seeks to make labor costs more competitive.

CHART I
NONFARM UNIT LABOR COST INDEX
(PERCENT CHANGE FROM A YEAR AGO)



Not surprisingly, employers' wage bills are rising much more slowly in this economic expansion than they have, on average, in the past. And when productivity growth is factored in, one finds that labor costs per unit of output in many sectors of the economy are either flat or declining. (Chart I). The biggest improvement in productivity has come in the manufacturing sector, as is usually the case, but the outlook is brightest in the service sector, thanks to the increasing application of new technologies. As long as productivity growth continues strong and wage settlements are moderate, unit labor costs will not rise rapidly. Since labor costs comprise approximately two-thirds of business costs, you can see why this trend alone should make one optimistic about inflation prospects.

International Factors Hold Prices Down

Notwithstanding the importance of labor costs, there are plenty of other reasons to expect the rate of inflation to remain moderate in the months immediately ahead. The degree to which the dollar has soared since mid-1980 has profoundly affected both

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business and labor in the United States. The strong dollar has opened previously closed markets to foreign competition because the cost of importing fell significantly as the dollar's foreign exchange value rose. In addition, because the strong dollar also meant that goods produced in the United States intended for sale abroad became very expensive, the net result was an overabundance of goods in the U.S. and a reduced ability on the part of many companies to raise selling prices. While the dollar has declined somewhat from its earlier peak, it is still believed to be significantly overvalued, compared with many other currencies, thus it is still keeping downward pressures on prices.

In this connection it might be worth noting two more factors on the international scene which will tend to keep a lid on prices. The first is the generally sluggish economic recovery worldwide. Most other countries that normally import goods manufactured in the U.S. are only now beginning to experience the first stirrings of an economic upswing. Obviously, slow growth limits their appetite for imported goods. In addition, the problems of some developing countries in servicing promptly their outstanding external debts suggest that they will be less in the market for imports, and will place greater emphasis on exports. This is because they have to turn around their trade positions from deficit to surplus, if they are to earn enough money to service their debts. Clearly, this will further increase the supply of goods on the market.

One item that is in big supply internationally is oil. It should not be forgotten that a good part of the reason for the escalation of inflation over the past ten years has been the sharp rise in the price of oil. But energy prices are no longer being set by only one side of the market. The balance between supply and demand has clearly tilted in favor of oil users. In spite of the tensions in the Middle East, this outlook is unlikely to change anytime soon. Our imports of crude oil and products have dropped significantly over the past ten years and are now at the lowest level since 1972. We are using no more gasoline today as a nation than we did back in 1973 with 24 percent more cars on the road. Industry's usage of residual fuel oil for heating and electric power generation is at its lowest level in over 30 years. Overall, our ratio of energy input to GNP output has changed dramatically from the 1:1 that characterized the half century to 1973, to as little as 1:6 today.

A good part of the reason for this better balance between supply and demand has come about because of deregulation. Begun in April 1979 by President Carter, deregulation was accelerated in January 1981 by President Reagan, who completely decontrolled domestic crude oil prices. The impact of removing these controls was dramatic: spot oil prices peaked shortly thereafter and have declined 33 percent since. A story similar to oil industry deregulation can be told for natural gas which is only partially decontrolled. Beginning in late 1979, as the prices of some categories of gas were decontrolled, levels of exploration for these types of gas rose as did its availability. As a result, prices of some types of natural gas fell about two-thirds at the wellhead, although, because of the partially decontrolled nature of natural gas markets, this drop is not yet fully visible in end-use prices.

The Importance of Deregulation

Energy is not all that has been decontrolled. Indeed, quite a few sectors have been deregulated with favorable results on supply and demand, thus, prices. Most prominent is the transportation sector. The Airline Deregulation Act of 1978 terminated the Civil Aeronautics Board's authority over domestic routes effective December 1981 and over domestic pricing effective January 1983. As a consequence, competition within the industry has increased, witness the fact that the number of certified airlines rose from 36 in 1978 to 154 currently. Removal of price controls and the increase in the number of airlines have caused prices to fall in many markets. Nearly twice as much domestic coach traffic operates under discount pricing today compared with six years ago. Deregulation has also promoted efficiencies within the airline industry as carriers have been forced to increase productivity and cut costs.

Another part of the transportation sector that has been deregulated is the railroads. The Staggers Rail Act of 1980 returned ratemaking to the railroads. It allowed the railroads to consolidate their operations, coordinate transportation of goods with motor carriers, and use contractual arrangements in the ratemaking process. The initial result of the Staggers Act was that rail freight rates rose more rapidly than before. However, this was because of a need to catch up with costs and markets. Once this is over with, rates should increase more moderately, especially for those users who make intensive use of the railroads for either shipping or transportation.

In trucking, economic deregulation has eased barriers to entry and promoted a more market-determined pricing structure. As a result, a significant increase in the number of new carriers has occurred, and even after making allowance for the greater failure rate, the number of firms in the trucking business today is clearly much greater than before. Not surprisingly, many shippers have been able to obtain lower rates. Deregulation has also affected labor costs as a result of competition from nonunion truck drivers and hard times for many motor carriers.

Other sectors of the economy have been or are in the process of being deregulated and these, too, will contribute to a moderation in price increases. In health care, new regulations designed to increase

competitive forces within the industry are already restraining the rate of health care inflation. In telecommunications, the restructuring of the telephone industry will ultimately bring major benefits to both that industry and its customers in the form of increased numbers of communication networks, services and products. Telecommunication technology also promises to help business in general improve its efficiency. Finally, financial services have been deregulated with one result, higher interest rates. These higher rates, coupled with the new savings and checking products that the banks can offer, will in time contribute to larger savings flows and less speculative borrowing. Obviously this will enhance capital formation, which is so necessary for business investment, while at the same time keeping spending patterns from becoming excessive.

Sticking with the financial area, one must not overlook the present thrust of Federal Reserve monetary policy. Although the Fed's commitment to monetarism may seem less than total to the diehards, it nevertheless is a key factor in its current monetary objectives. Of course, there are those of the monetarist persuasion who would argue that the Fed has already compromised its stance on inflation. They point to the sharp rise in the money supply that occurred from the middle of 1982 to the middle of 1983. However, nonmonetarist economists would not necessarily agree with this conclusion for several reasons. For one thing, part of the rapid increase in the basic money supply was the result of inflows of investment funds into NOW and Super-NOW bank accounts.

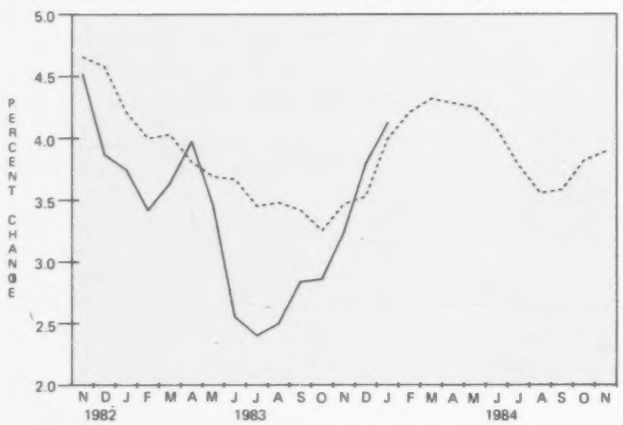
Since depositors can obtain money market rates on these checking accounts, it is conceivable that a big chunk of these funds might not be money available for spending, but simply another form of savings. In addition, the velocity, or turnover of money, fell much more than usual during the last recession and has yet to regain its previous peak, suggesting that there has been a secular change in the relationship between money and the economy. As a matter of fact, the drop in velocity was so steep that for the first time in modern history, it is not only below its prerecession peak in the second year of economic recovery, but it is no higher than levels first reached four years earlier. One wonders if the Fed has been liberal enough in providing money to the economy, rather than being overly generous to the point of starting a new round of inflation and the expectation of inflation.

Regarding inflation psychology, one need only look at the real world to see a dramatic change. Well into the second year of economic recovery many businessmen still complain that they cannot raise prices even where markets have firmed. For their part, consumers remain reluctant to pay higher prices, preferring to shop around or do without. This anti-inflation psychology can also be seen from a look at the precious metals. At roughly $400 an ounce, gold is less than half the peak price reached four years ago; silver is less than one-fifth its 1980 price. And the precious metals are not the only commodities that are below their previous peaks. Besides oil, many food commodities remain below their earlier highs as are such key industrial commodities as copper, aluminum, and lumber.

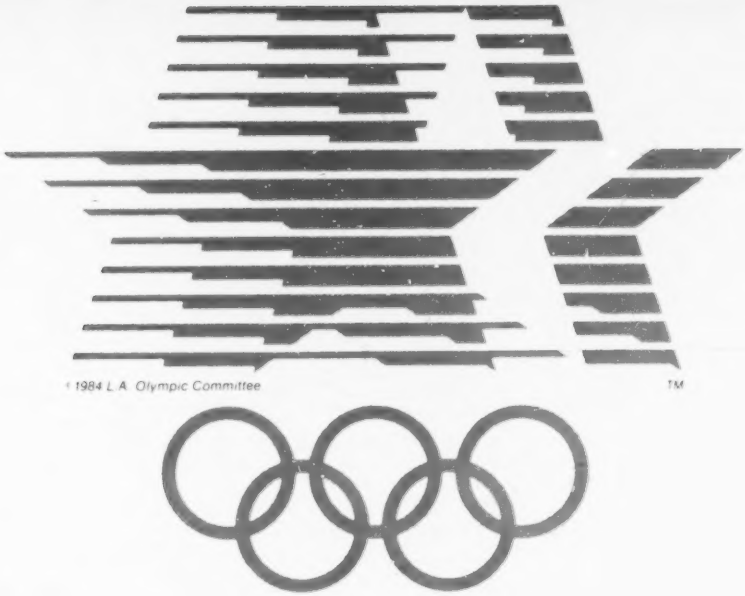
Conclusion

It is true that the various price indexes have risen more rapidly in the past six months than previously. The consumer price index, for example, has gone up at a five percent annual rate in the past six months compared with a 3½ percent rate of rise in the previous half year and less than a two percent clip during the six prior months. Even taking out the noncyclical influences of food and energy, the fact remains that the underlying rate of inflation has picked up. However, this should not be worrisome. The recent acceleration in inflation looks bad only in comparison with its earlier slowing, which was much greater than average (Chart II). You will recall, for example, that between October, 1982 and February, 1983 the overall consumer price level fell—the first four-month decline since 1958.

CHART II
12-MONTH PERCENT CHANGE IN CONSUMER PRICE INDEX
CURRENT RECOVERY (LINE) VS.
AVG. OF 7 PRIOR RECOVERIES (DOT)



The fact that inflation has picked up a bit is not unusual in the second year of an economic recovery. However, the odds seem against the rate of inflation accelerating much beyond current levels. If inflation does remain close to its present rate, it will mean that we will have gone a full cycle ratcheting downward the rate of inflation after six cycles of seeing inflation worsen. And just as the previous stepups in inflation turned out to be self reinforcing, so this step down in inflation should be a signal to the various economic and political units in the United States and worldwide that, at long last, we may have, indeed, turned the corner in the battle against inflation, and may be heading toward eventual price stability. H



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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
Senior Vice President
and Economist

APRIL 1984

Debt Bomb Defused?

Since summer 1982, the issue of developing country debt has become an increasing preoccupation among both the media as well as the analysts on Wall Street. This has not been without good reason, in view of the well-documented inability of some developing countries to fully service their debt. However, another trend has developed during this time which has not received as much publicity. This trend deals with changes in the economic fundamentals that led to the country debt problem in the first place. These changes, if nothing else, have bought much-needed time to implement a more permanent solution.

Lower Interest Rates ...

Let's look at the big picture first. As you will undoubtedly recall, interest rates have receded. Although up from their lows reached about a year ago, most interest rates here and abroad remain substantially below their 1980-82 peaks. In turn, this has produced at least two beneficial effects. First, of course, it has lowered the cost of servicing debt. It is believed that each percentage point decline in market rates of interest saves such countries as Mexico and Brazil nearly three quarters of a billion dollars a year each in interest costs alone.

The second effect of lower interest rates is equally as important. It allowed economic recovery to get underway in the United States and in other major industrial countries. In turn, this expanded the markets for many of the goods produced and exported by these debtor nations. Our burgeoning deficit in merchandise trade is testimony to this: In 1983 the U.S. ran a record merchandise trade deficit with the rest of the world—taking in $61 billion more in imports than it sent abroad in exports. Of this, over $16 billion, or 26¼ percent, reflected a deficit in trade with Latin America. Of course, a deficit for us means a surplus for them, thus expanding their net export income.

More goods exported, by themselves, do not necessarily enhance a country's ability to service its debt. Other adjustments must be made as well—and these have been made. For one thing, imports have been slashed. In some cases, the flow of merchandise into developing countries has been cut by more than 50 percent. This was accomplished by a combination of policies, some good and some bad.

... Belt-Tightening ...

In an effort to improve their trade and current accounts, many developing countries tightened their belts significantly. Taxes were raised, government spending was cut while domestic interest rates were increased. To further help cut imports and promote exports, these debtor countries devalued their currencies in the foreign exchange markets. However, to hasten the process, some also turned to trade and capital controls, in order to ensure that the import of goods and the export of capital would be cut down.

TABLE I

MERCHANDISE TRADE AND CURRENT ACCOUNT BALANCES OF SELECTED DEVELOPING COUNTRIES

(billions of U.S. dollars)

	Merchandise Trade			Current Account		
Country	1981	1982	1983	1981	1982	1983
Argentina	0.7	2.7	3.5	4.7	−2.4	−2.5
Brazil	1.2	0.8	6.5	−11.7	−14.5	−6.2
Chile	−2.4	0.3	1.0	−4.7	−2.3	−1.1
Mexico	−4.1	6.9	11.7	−12.5	−2.7	3.5
Peru	−0.5	−0.6	0.1	−1.7	−1.7	1.1
Venezuela	7.8	2.7	7.0(e)	4.0	1.5	2.0
6 High Debt Latin Countries	2.7	12.8	29.8	−21.9	−22.1	−3.2

Source: International Monetary Fund

As you can see from Table I, the net result was nothing short of dramatic. Both the trade and current accounts of the major Latin American developing countries have improved markedly. On the merchandise trade basis, the six high debt Latin countries boosted their aggregate trade surplus from less than $3 billion in 1981 to nearly $30 billion in 1983—a tenfold increase! Shifting to the current account, the six high debt Latin countries

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ran a combined current account deficit of nearly $22 billion in 1981. Two years later, this was slashed to little more than $3 billion—an 85 percent improvement.

The combination of lower interest rates and rising earnings on the export of goods and services has improved the debt service ratios of many developing countries, as has the stretchout of the repayment of principal. Table II shows that the ratio of interest payments to exports of the six high debt Latin countries declined from 35.8 percent in 1982 to 35.2 percent in 1983. As these countries have once again begun earning more abroad than they spend abroad, their reserves have been bolstered. Table III shows the extent to which the high debt countries' reserves can cover their import bills. In 1982, the six high debt Latin countries could cover only 4.7 months' imports with their reserves; by 1983, with imports reduced and bank balances rising, this improved to more than six months.

TABLE II

DEBT SERVICE RATIOS OF SELECTED DEVELOPING COUNTRIES

(billions of U.S. dollars, percent)

	Interest Payments		Export Earnings (goods and services)		As % of Exports	
Country	1982	1983	1982	1983	1982	1983
Argentina	2.972	2.904	10.657	11.092	27.9%	26.2%
Brazil	12.550	12.270	23.507	25.512	53.4	48.1
Chile	2.041	2.256	4.932	5.401	41.4	41.8
Mexico	10.499	11.234	30.717	29.758	34.2	37.8
Peru	1.229	993	3.884	3.906	31.6	25.4
Venezuela	4.151	3.941	19.500	19.790	21.3	25.8
6 High Debt Latin Countries	33.392	33.598	93.197	95.459	35.8	35.2

Source: International Monetary Fund

Perhaps the key economic fundamental responsible for the country debt crisis was the sudden rise in oil prices some ten years ago. As you will recall, this caused the oil exporting countries to develop massive foreign trade surpluses. To compound matters, the oil-exporting countries were initially inclined to invest the biggest portion of their revenues in assets of very short maturities. Furthermore, the oil exporters directed their investments into those countries and currencies that promised the greatest safety of principal. Thus, large amounts of money flowed into the United States, landing mainly in Treasury bills and in the major U.S. banks.

Meanwhile, those countries that were importers of oil soon developed very large trade deficits. Indeed, for the first time in modern history, the same countries ran consistent and growing payments deficits year after year because the price of oil was permanently altered relative to the giant matrix of commodities worldwide.

TABLE III

RESERVES TO IMPORT RATIOS OF SELECTED DEVELOPING COUNTRIES

(millions of U.S. dollars)

Country	Latest Month	Total Reserves (including gold)	Average Monthly Imports (1983)	Year-Earlier Import Cover (in months)	Latest Import Cover (in months)
Argentina	11/83	2,638.0	317.8	7.7	8.3
Brazil	12/83	4,582.5	1,284.2	2.5	3.6
Chile	12/83	2,696.4	186.8	8.3	14.4
Mexico	10/83	3,828.0	1,207.4	1.5	3.2
Peru	9/83	2,423.7	315.6	5.7	7.7
Venezuela	1/84	11,037.0	1,132.0	8.8	9.8
6 High Debt Latin Countries		27,205.6	4,443.8	4.7	6.1

Source: International Monetary Fund

... And Higher Commodities' Prices ...

However, as you can see from Table IV, the relative price trend of oil versus other commodities has changed dramatically since the end of the U.S. recession in 1982. Industrial raw material prices have climbed 26 percent during this time while agricultural prices are up 27 percent. By contrast, the spot market price of oil fell 14½ percent during this time. The importance of this development should not be underestimated. Quoting from the January 1983 Economic Report: "Prices of the goods that developing countries export must return to their proper position relative to other prices especially oil, if these countries are ever to reduce their debts to more manageable proportions."

Notwithstanding these rather impressive economic accomplishments, there remain clouds on the country debt horizon. For one thing, the maturity structure is still too short. Although the proportion of developing country external bank debt due within one year has decreased somewhat, it is still uncomfortably high. While only 34 percent of U.S. government debt is due within one year and 48 percent of Corporate America's debt has the same structure, nearly 53 percent of the debt of the six major Latin debtors has a one-year maturity. Obviously, the more debt with a short maturity, the more it must be rolled over.

Besides the almost continuous need to refinance, short-maturity debt tends to be sensitive to market rates of interest. And all too often, market interest rates are determined by conditions in the United States such as Federal Reserve monetary policy, as well as Washington's budget deficits and associated Treasury financings. To the extent both impact the dollar's exchange rate, you can see where yet another burden is being placed at the doorstep of the debtor nations that is not within their control. The January 1983 Economic Report

discussed the need for the development of a mechanism to allow countries to reduce their dependence on fluctuations in the cost and availability of short-term credit, pointing out that debt burdens could be reduced "if a facility were made available to governments that would permit them to exchange short-term debt for long-term debt (or equity) as private sector companies do." The sooner we can reduce the current round of ad-hoc reschedulings, the sooner confidence will return to both the banking system and the borrowing countries. That we are heading in such a favorable direction can be seen from the multi-year rescheduling of maturities now being negotiated.

Despite this, country debt will continue to be extremely sensitive to interest rate developments mainly as they originate in the United States. The burden for the developing countries comes from the cost of money—not the interest rate spread. While there is a growing recognition among bankers that some adjustment of interest rates charged on loans to developing countries might be necessary, central to money costs are U.S. fiscal and monetary policies. If Washington were to make meaningful progress in reducing its budget deficit, interest rates would probably fall without the Federal Reserve having to pump money in and risk a new round of inflation.

TABLE IV

COMMODITY PRICE TRENDS

	November 1982	Latest Month	% change from Recession Trough
Raw Industrials Index (1967 = 100)	229.30	289.60	26.2
Agricultural Products Index (1980 = 100)	73.50	93.30	26.9
Cacao, Brazil (cents/pound)	60.42	90.41	49.6
Cotton, Egypt (cents/pound)	123.80	162.85	31.5
Rubber (cents/pound)	42.10	57.30	36.1
Soybeans ($/Metric ton)	213.00	237.00	11.3
Sugar, Brazil (cents/pound)	8.27	11.59	40.1
Metals Index (1980 = 100)	74.60	74.40	−0.3
Bauxite (cents/pound)	198.72	168.28	−15.3
Copper (cents/pound)	71.57	67.39	−5.8
Iron Ore (cents/pound)	25.17	22.30	−11.4
Nickel (cents/pound)	320.00	320.00	0.0
Tin (cents/pound)	564.00	566.00	0.4
Petroleum (dollars/barrel) Saudi Arabia (Ras Tanura)	33.40	28.60	−14.4

Sources: International Monetary Fund, Commodity Research Bureau Inc.

On the other hand, the Fed should allow enough money into the system to keep the U.S. economy growing. It is one thing for the Federal Reserve to want to achieve slower economic growth in order to avoid overheating and a revival of inflation. It is quite another to pursue this objective to the point where the risk of recession rises—as might be the case in 1985. But a recession is not necessary to put the kibosh on the improvement in country debt; enough of a slowing of U.S. economic growth will produce the same result. For less growth here means reduced demand for products produced from abroad—especially from the borrowing countries. In turn, this would reduce their exports, and, possibly, the prices of the commodities they sell abroad as well. Clearly, this would cut into export earnings with results not hard to imagine. As it is, exports from many developing countries are running into the wall of protectionism thrown up by the U.S. and other industrial countries in the name of helping domestic industries. These protectionist walls have to come down if debtor nations are to have a chance of getting back on their feet.

... Improve Developing Country Finances

Of course, these debtor nations have a lot they must do for themselves. There is an obvious need among the major debtor countries in Latin America to make more progress in significantly reducing their inflation rates. In the overwhelming number of cases, year-on-year inflation in 1983 was far worse than in previous years—a development only partially explained by their depreciating foreign exchange rates. Naturally, slowing down inflation in these countries where living standards have already been squeezed to the bare minimum by currency devaluations, import restrictions, and other stringencies will not be easy. However, it must be done if these nations are to return to the economic playing field as healthy and equal participants.

In sum, the nature of the country debt situation has changed compared with 1982. Then, it was economic in scope as a result of the combination of four years of recession, high interest rates, declining commodity prices and soaring oil prices. But adjustments have been made by the borrowing countries, helped by a reversal of these external economic circumstances: An economic recovery, declining interest rates, rising commodity prices and falling oil prices. The ultimate objective, of course, is for the borrowing nations to return to enough of a state of financial health so they can access the credit markets normally. While much needs to be done—more in some countries than in others and over longer periods of time—much has already been achieved.

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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
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MAY 1984

A New Ball Game

Every so often, a major development takes place which has long-lasting effects on individuals, businesses, and governments. Sometimes its impact is immediately recognizable—but other times its meaning becomes clear only after considerable time has elapsed. These developments can take many forms. They may be economic, political, military, or technological in nature.

In recent years we seem to have been inundated with a variety of these changes. Politically, we have had to contend with assassinations and resignations of government leaders. Militarily, we seem to have shifted from fighting major wars to becoming involved in a variety of minor skirmishes. The technological revolution is still underway, but it has already produced major changes in the way business is run, information transmitted and analyzed, and money managed.

The economic sphere has seen its share of changes, too. Back in 1973, the U.S. and other countries adapted generalized floating foreign exchange rates. Also, the first oil "shock" occurred, in which oil prices were increased dramatically and oil supplies were restricted. The ramifications of these developments are still being felt. On the policy side, 1975 marked the beginning of intense Federal Reserve-watching by the financial community, thanks to the agreement between the Fed and the Congress regarding the publishing of annual targets for growth rates of the money supply. When, in 1979, the Federal Reserve began to place more emphasis on the money supply, Fed-watching grew even more intense and the financial markets became extremely jumpy. Fiscal policy has changed, too, with the passage of the Economic Recovery Tax Act of 1981 and the huge deficits that arose in its wake. We have yet to see the full impact of this development.

Now there is another change. I speak of leveraged buyouts. A leveraged buyout, or LBO, is the acquisition of a company by a buyer (usually with a part of the management team) that is financed to a substantial degree with borrowed funds secured by the firm's assets, based on its cash flow, or both. If the name is new, the concept isn't. This kind of transaction has been around for a half century or more. At that time, the deals were called "bootstrap financing."

The modern LBO first appeared in the early 1970s, when, in the wake of a depressed stock market, owners of privately held companies who wanted to take their money out of their company, sold out to a group including some of their managers put together in the form of an LBO. Later on in the decade, diversified companies began to sell off subsidiaries that were not living up to expectations, either from the point of view of growth or long-term strategies. Frequently, the buyers for these operations were equity pools, which brought in their existing managers who also put up small amounts of money.

LBOs Improve Efficiencies...

It soon became apparent that companies were run differently under these new arrangements. Owner-managers seemed to run the companies much more efficiently than they had when they were drawing a salary and managing the company on behalf of absentee owners. And that brings me to some of the changes that have either already occurred as a result of these LBOs, or are likely to occur in the future.

Perhaps the first thing that a manager-owner feels he must do upon taking over an LBO-financed company is to improve efficiency. Since he had to put up some of his own funds as part of the deal, he has a greater stake in the success of the company than he had before. Instead of being just a manager, he now has become a stockholder. And having an equity stake in the business, it is natural that he wants the business to be run as efficiently as possible. This is not to imply that publicly-held companies run by professional managers are not efficient; they certainly are and have contributed greatly to the growth of our economy and the improvement in our standard of living. However, I

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think you can appreciate the greater incentive that comes from being a manager-owner, when there is more at stake than simply general corporate objectives.

Some of this may already be apparent. Productivity, or output per hour worked, is increasing strongly. Although part of this rise no doubt reflects the normal gains in efficiencies that accompany the early stages of an economic recovery, part seems to go beyond the business cycle. To be sure, there has been more research and development, leading to technological changes which have spurred business purchases of computers, word processors, telecommunications facilities, and robotics for assembly lines. Also, the Economic Recovery Tax Act of 1981, which instituted the accelerated cost recovery of capital expenditures, deserves some credit. Nevertheless, my guess is that at least a small portion of the current improvement in productivity is also a product of the growing conversion to manager-owners.

...Reducing Price Pressures

Of course, greater efficiencies will lead to less pressure on prices. Indeed, because the manager-owner is even more concerned about sales levels, he might be extremely reluctant to raise prices. Increased productivity allows him to accomplish this objective. The result for the economy, of course, is less inflation.

Since labor costs comprise approximately two-thirds of business costs, any effort to hold the line on prices has to include smaller wage increases. I find it very interesting that wage settlements remain moderate even though labor markets have improved dramatically so far in the current recovery. Some of this must trace to labor's reduced bargaining power when a public company goes private.

A year and a half into this expansion finds the unemployment rate down faster than for this point in any previous recovery in the past 30 years. At the same time the employment numbers have risen faster than in any recovery since 1950. You would think that this would have caused labor to be more aggressive in its wage and salary demands—but it has not. The Labor Department tells us that major collective bargaining contracts settled in private industry continue to yield the lowest average wage adjustments in the history of this series. Combining these small wage increases with the ongoing strong trend in productivity leads to unit labor costs that are rising at their slowest pace since the mid-1960s.

Another aspect of efficiency that may already by showing up in the general run of statistics deals with inventory levels. As you will recall, inventories during the last recession were liquidated at a record pace. This liquidation kept up until about a year ago—well into the economic recovery—eventually producing the lowest overall ratio of inventories to sales in the postwar era. And although inventories have been growing since last summer, they still remain low relative to sales. No doubt such factors as the high real cost of money, the growing use of computers, and the lack of inflation psychology have motivated businessmen to keep inventories on the lean side. However, I would bet that the growing number of companies now run by their owners has played a part, too.

Lest you think that I am exaggerating the effect LBOs have on inventory levels, wage settlements, or inflation, I would like to point out that their impact may be far greater than may be discerned from counting the number of companies that have gone the LBO route compared with the total business population. This is because in most industries, when a low-cost producer emerges, it will affect others in that industry.

If the low-cost producer chooses to sell goods or services at the same price that other higher-cost producers do, that low-cost producer will obviously earn more money and either spur new entrants or encourage the others already in the industry to lower their costs so they can earn more, too. On the other hand, should the low-cost company choose to reduce its selling prices (or hold the line when others go up), it will also prosper, this time by increasing its share of market. Again, the onus will be on the others to match the price and cost structure of the most efficient firm.

In other words—while the number of companies that have gone the LBO route is relatively small, hence the number of products sold, the number of employees affected, and so forth is tiny, these LBOs may well have already had a disproportionate impact on the economy through their effects on their competitors.

Reported Profits Sacrificed...

One statistic yet to be materially affected by the trend to LBOs, but which certainly will be if this trend continues, is reported profits. Once a company goes private, speeding up cash flow becomes the high-priority item on the manager-owner's agenda, because of the need to retire the loans as quickly as possible. This can involve writing up the company's assets, which may have been acquired years ago at much lower prices, to present cost levels, making it possible to charge more depreciation based on the new, higher book value. Since depreciation is a subtraction from total revenues, this has the effect of lowering reported profits. Or it can involve the use of an NOL (net operating loss) partner

to shelter reported earnings, thereby also increasing cash flow.

Another subtraction from earnings is the interest that is paid on the debt incurred in the process of the buyout. Interest payments on borrowed money, as you know, are tax deductible, while dividends paid to stockholders are not. Therefore, the combination of greater depreciation writeoffs or an NOL partner, and larger interest payments will affect reported profits. And if reported profits are lower, so are tax revenues to various levels of government. Indeed, most companies in the early years following a buyout pay little corporate tax. These lower tax revenues may soon be more than just a statistic—they might affect the budget positions of various governments if they become more widespread.

Looking for other implications of the trend to LBOs, one can draw analogies to those privately held companies that have been around for quite some time. So far, most privately held companies have been small businesses. And it is a fact that small business has done better than big business in driving economic growth in recent years. Why are small businesses so successful? Very simple. A privately held company, having closer control over ownership, can implement long range goals to increase productivity and profits and can be managed with more sensitivity to business trends and the world market. Without the need to communicate company strategies to public stockholders, managers in privately-held comanies are under less pressure to produce quarterly results for stockholders. Thus they are freer to sacrifice present gains for longer range goals that will benefit the company.

...For Long Range Goals

Part of taking a longer range view involves quicker depreciation methods and frequent updating of technology, which, as noted above, is common for leveraged buyouts. Privately-held companies, without the need to explain short-run profit trends to shareholders, are quick to discard outmoded equipment in order to take advantage of the latest technological breakthroughs. Writing these off produces less profits—but not necessarily less cash flow—and of course, it makes the company more competitive from a longer-run standpoint.

Although a lot of today's lending to individuals, companies and countries is being made at floating rates of interest, the trend toward leveraged buyouts may decrease the economy's sensitivity to interest rates. This is because more and more LBOs are now carrying fixed rates of interest. This is being accomplished through swaps and options. Indeed, last year only 37 percent of all loans made domestically carried floating interest rates, down from 54 percent five years ago. One wonders if this reduced impact might not eventually force the Federal Reserve to rethink its monetary policy strategies and objectives.

It seems to me that a new ball game may be getting started—the kind of game that was first played when the U.S. economy was in its infancy. Then, companies were specialized, producing one product or a narrow line of products or services. There was no such thing as a conglomerate. Also, if one company wanted to buy another, such a transaction could only be consummated on friendly terms, since there were no public shareholders who could be attracted. It may well be that a continuation of this trend towards private ownership will at least slow the recent trend toward corporate raiders and their "greenmail" tactics.

A lot of criticism has been levied lately at corporate executives. It has been charged that they seem to be more interested in themselves than in the shareholders of the company for whom they work. At issue is whether these executives are still accountable to the company's owners. They are accused of lavishing substantial salaries and bonuses on themselves, as well as conferring such amenities upon themselves as luxury cars, corporate jets, and apartments. Boards of Directors, theoretically representing shareholders, are said to serve at the pleasure of managements.

These charges are, for the most part, not true. However, one thought comes to mind: Once managers become owners, they think and act like owners. Those who criticize corporate America because of the separation of management and ownership that characterizes the corporate structure should look more kindly on leveraged buyouts, if for no other reason than this.

On the other hand, LBOs have been criticized for the amount of debt involved and what might happen if interest rates rise sharply and the economy slows down. Indeed, some have called LBOs, the REITs (Real Estate Investment Trusts) of the 1980s. I would answer these charges by pointing out that, in addition to the trend towards fixing interest rates, many LBOs have cash caps which shield cash flow from the effect of rising rates through a supplementary borrowing facility. As for the REIT comparison, it should be noted that LBOs involve direct lending, rather than indirect, as was the case with REITs. Also, the REITs obviously involved only one industry—real estate—which made them extremely sensitive to economic and financial developments. LBOs cut across a wide variety of industry groups—if anything, making them *less* sensitive to the state of the economy.

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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
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JUNE 1984

Business Conditions Update

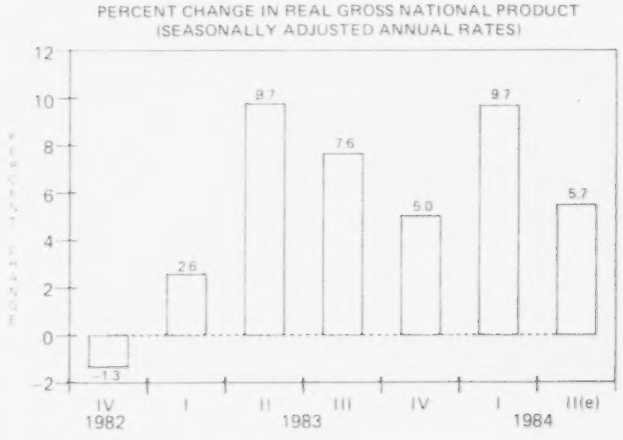
Midyear 1984 finds the U.S. economy in a state of transition. The rate of growth in the gross national product during the second quarter was less than that of the first—although not as little as economists had hoped (chart). On the other hand, inflation, as measured in the GNP accounts, slowed to an annual rate of only 2.8 percent from 3.9 percent in the first quarter.

Continued Growth...

The second quarter's still-strong rate of growth might be taken as a sign that another contraction in business activity is not far away. This is because interest rates are likely to move higher in such a strong-growth environment. And it was high interest rates that helped push the economy into the last recession.

A recession does not seem to be in the cards—at least for this year. This is because past recessions have also followed either excessive stockbuilding by the private sector, or spiraling inflation. In the case of stockbuilding, businessmen usually react to the discovery that they have more goods on hand than necessary by slashing production lines, laying off workers and reducing orders from suppliers. You can imagine how this could produce a recession by cutting into buying power. As for inflation, it eventually prompts the public sector to step on the brakes and restrain economic activity in order to bring the rate of inflation down.

Turning back to inventories, it must be acknowledged that there was a sizable buildup of inventories in the private business sector during the first quarter. Indeed, the increase in business inventories was a record for any calendar quarter both in nominal and in inflation-adjusted terms. What is more, the record is pretty firm on the contribution that excess stockbuilding makes to the business cycle: It peaks just at the end of an economic expansion. I don't think there is reason for worry this time, however. This is because the ratio of inventories to sales remains low. This ratio is not the lowest it has ever been, but it is far from levels reached in past business expansions just prior to the onset of recession. Furthermore, corporate executives are more aware of the need to keep inventories low—and more able to accomplish these objectives. The high real cost



of money and a decided lack of inflation psychology are two excellent reasons why companies are not likely to let inventories rise too rapidly this time around. And the growing use of computers enables many businesses to have a better idea of how orders are coming in, how sales are doing, where inventories are and how much inventory is needed to support a given level of sales.

Business people are lifting their sights when it comes to

NO REPORTS IN SUMMER

The Economic Report will not be published during July and August. The next issue will appear in September

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capital spending, however. And if they carry out their latest plans, the economy will get a boost in several ways. The Commerce Department's latest survey of corporate spending intentions suggests that such outlays will rise this year compared with 1983, after falling for two consecutive years. The projected increase, 15 percent, would be the largest percentage increase for any year since 1979, in nominal terms, and would exceed all annual gains in the past 18 years, when adjusted for inflation.

When businesses spend more on capital goods, it increases the demands on those industries that produce the capital goods. This means more employment, more materials and supplies, as well as financial and other services. You can see where this would have a ripple effect throughout the economy. Additionally, as the new capacity comes onstream, it adds to industry's ability to turn out goods without the shortages and bottlenecks which usually lead to inflation. And by replacing outmoded machinery and equipment with the latest technological developments, it makes industry more efficient, further helping to contain inflation.

...With Moderate Inflation

Notwithstanding the fears and predictions by economists, Wall Streeters and many others, inflation has remained tranquil so far in this economic recovery. Eighteen months into the current expansion finds prices, as measured in the GNP accounts, rising by the smallest percentage in over 20 years. Producer prices are up only half as fast as they have been at this point in previous expansions. What is more, there does not seem to be anything on the horizon to disturb this favorable comparison. Prices of industrial raw materials have been essentially level this year, and are still more than 12 percent below the peaks reached early in 1980. Farm commodities prices are also below their 1980 peaks. In addition, as noted in the March 1984 Economic Report, labor costs continue to grow moderately. Wage increases remain small while productivity gains are still healthy.

There are other factors contributing to the lid on inflation. The strong dollar has helped hold prices down by restraining exports and encouraging the inflow of lower-priced imports. This not only has resulted in more goods available for domestic consumption, it has made many U.S. companies very cautious in their pricing policies, lest they lose share of market to lower priced imported goods. Deregulation of oil, transportation, health care, telecommunications and the financial sector is also helping to restrain price increases.

One should not overlook the importance of monetary policy in keeping inflation at bay. In the past, the Federal Reserve would wait until it saw the whites of inflation's eyes before moving to tighten the supply of money and credit. Invariably, this would result in an overreaction—and a recession. This time around, the Fed tightened early—before inflation worsened materially. It is generally acknowledged that the Fed changed its posture about a year ago, following about ten months of aggressive ease. This shift in monetary strategy is one reason why interest rates remain comparatively high. But at least it has minimized the possibility of a liquidity-induced upsurge in inflation, near term.

The uptick in interest rates over the past year is beginning to slow economic activity. For one thing, with mortgage rates now close to 15 percent for a fixed-rate conventional loan, sales of single-family homes have begun to fall. If this continues, it will result in a rise in the number of unsold homes and will cause builders to cut back the rate of new housing starts. Obviously, this will have an impact on workers and suppliers to the building trades—not to mention sales of home furnishings. New car sales don't seem to be growing this year the way they did last year, and this may be due in part to higher interest rates besides shortages of popular models. Earlier this month, Detroit had only a 47-day supply of domestic cars on hand at then-current selling rates—well below the 60-65 day level that usually prevails at this time of year. Retail sales in May virtually flattened, while industrial production rose only one-third as fast as in April.

June, 1984

MHT FORECAST OF GROSS NATIONAL PRODUCT
(Seasonally Adjusted Annual Rates)
In $ Billions

	< Actual						Projected >					
	1983				YEAR 1983		1984				YEAR 1984	
	1	2	3	4	LEVEL	% CH	1	2	3	4	LEVEL	% CH
Gross National Product	3171.5	3272.0	3362.2	3436.2	**3310.5**	**7.7**	3550.1	3624.8	3693.0	3762.4	**3657.6**	**10.5**
GNP: $72	1490.1	1525.1	1553.4	1572.5	**1535.3**	**3.4**	1609.3	1632.0	1647.6	1662.0	**1637.7**	**6.7**
% Change, Annual Rates	2.6	9.7	7.6	5.0	**3.4**		9.7	5.7	3.9	3.5	**6.7**	
Consumption	2073.0	2147.0	2181.1	2230.9	**2158.0**	**8.3**	2286.2	2341.5	2394.2	2436.8	**2364.7**	**9.6**
Durables	258.5	277.7	282.8	298.6	**279.4**	**14.3**	315.1	329.5	342.0	348.3	**333.7**	**19.4**
Non-Durables	777.1	799.6	814.8	825.0	**804.1**	**5.7**	843.2	861.1	875.1	888.2	**866.9**	**7.8**
Services	1037.4	1069.7	1083.5	1107.3	**1074.5**	**8.9**	1127.9	1151.1	1177.1	1200.3	**1164.1**	**8.3**
Investment	404.1	450.1	501.1	532.5	**472.0**	**13.9**	604.6	610.6	615.1	627.7	**614.5**	**30.2**
Non-Residential	332.1	336.3	351.0	374.0	**348.3**	**0.0**	385.7	400.7	412.1	422.3	**405.2**	**16.3**
Producers Durable Equipment	199.3	208.8	220.2	240.7	**217.2**	**5.2**	245.6	255.4	262.3	268.4	**257.9**	**18.7**
Structures	132.9	127.4	130.9	133.3	**131.1**	**-7.6**	140.1	145.3	149.8	153.9	**147.3**	**12.3**
Residential	111.3	128.4	141.5	138.8	**130.0**	**43.3**	147.8	154.8	154.5	152.2	**152.3**	**17.2**
Inventory Changes	-39.4	-14.5	8.5	19.6	**-6.5**		71.0	55.1	48.5	53.2	**57.0**	
Net Exports	17.0	-8.5	-18.3	-26.1	**-9.0**		-48.2	-71.0	-77.1	-80.1	**-69.1**	
Government Purchases	677.4	683.4	698.3	699.0	**689.5**	**6.2**	707.6	743.7	760.8	778.0	**747.5**	**8.4**
Federal Defense	194.4	199.4	201.2	206.3	**200.3**	**11.6**	212.7	217.8	223.0	227.6	**220.3**	**10.0**
Federal Civilian	79.1	74.3	76.9	67.8	**74.5**	**-6.0**	59.2	81.1	83.8	86.7	**77.7**	**4.2**
State & Local	404.0	409.7	420.2	424.9	**414.7**	**6.2**	435.7	444.8	454.0	463.7	**449.5**	**8.4**
Final Sales: $72	1505.5	1530.5	1549.7	1563.7	**1537.4**	**2.8**	1578.6	1608.8	1627.4	1640.1	**1613.7**	**5.0**
% Change, Annual Rates	0.6	6.8	5.1	3.7	**2.8**		3.9	7.9	4.7	3.2	**5.9**	
GNP Price Index (1972 = 100)	212.8	214.6	216.4	218.5	**215.6**	**4.2**	220.6	222.1	224.1	226.4	**223.3**	**3.6**
% Change, Annual Rates	5.5	3.3	3.6	3.9	**4.2**		3.9	2.8	3.7	4.1	**3.6**	
PCE Deflator (1972 = 100)	210.1	212.5	214.7	216.1	**213.4**	**3.9**	218.1	219.5	221.6	223.8	**220.8**	**3.5**
% Change, Annual Rates	2.1	4.6	4.2	2.6	**3.9**		3.8	2.7	3.9	4.0	**3.5**	
Consumer Price Index (1967 = 100)	293.6	296.8	299.8	303.1	**298.3**	**3.2**	306.8	309.8	313.3	316.8	**311.7**	**4.5**
% Change, Annual Rates	0.3	4.3	4.2	4.4	**3.2**		5.0	4.0	4.6	4.5	**4.5**	
Total Personal Income	2657.8	2713.6	2761.7	2835.3	**2742.1**	**6.3**	2926.3	2977.4	3024.9	3076.5	**3001.3**	**9.5**
Disposable Personal Income	2255.9	2301.0	2361.7	2423.9	**2335.6**	**7.3**	2504.9	2547.6	2587.6	2630.6	**2567.7**	**9.9**
Savings Rate	5.4	4.0	4.9	5.2	**4.9**		5.9	5.3	4.6	4.5	**5.1**	
Employment Rate	55.6	55.9	56.6	57.0	**56.3**		57.5	58.1	58.4	58.7	**58.2**	
Unemployment Rate	10.4	10.1	9.4	8.5	**9.6**		7.9	7.6	7.3	7.2	**7.5**	
Indus. Production (1967 = 100)	138.5	144.5	151.8	155.5	**147.6**	**6.4**	159.8	164.3	166.9	169.2	**165.0**	**11.8**
Housing Starts (000)	1643.3	1690.3	1781.7	1698.7	**1703.5**	**61.3**	1968.0	1866.5	1767.9	1662.1	**1816.1**	**6.6**
Domestic Auto Sales (000)	6066.7	6933.3	6947.7	7220.7	**6792.1**	**18.0**	8266.7	8343.2	8374.8	8411.2	**8349.0**	**22.9**
Corporate Pre-Tax Profits	169.7	203.3	229.1	228.2	**207.6**	**19.2**	244.3	245.6	249.1	253.7	**248.2**	**19.6**
- Taxes	61.5	76.0	84.9	85.3	**76.9**		92.7	92.9	94.5	96.6	**94.2**	
Net Profits	108.2	127.2	144.1	142.9	**130.6**	**13.5**	151.6	152.8	154.6	157.1	**154.0**	**17.9**
- Dividend Payments	71.4	72.0	73.7	75.9	**73.3**	**6.7**	78.2	80.6	83.0	85.3	**81.8**	**11.6**
Undistributed Profits	36.7	55.2	70.4	67.0	**57.3**	**23.6**	73.4	72.2	71.6	71.8	**72.2**	**26.0**
+ Depreciation	242.2	255.4	270.7	281.4	**262.4**		288.3	297.4	307.3	317.4	**302.6**	
- Inventory Profits	1.7	10.6	18.3	6.3	**9.2**		12.5	16.5	22.9	25.5	**19.3**	
Net Cash Flow	277.2	300.0	322.8	342.1	**310.5**	**19.9**	349.2	353.2	356.0	363.7	**355.5**	**14.5**

The uptick in interest rates over the past year is beginning to slow economic activity. For one thing, with mortgage rates now close to 15 percent for a fixed-rate conventional loan, sales of single-family homes have begun to fall. If this continues, it will result in a rise in the number of unsold homes and will cause builders to cut back the rate of new housing starts. Obviously, this will have an impact on workers and suppliers to the building trades—not to mention sales of home furnishings. New car sales don't seem to be growing this year the way they did last year, and this may be due in part to higher interest rates besides shortages of popular models. Earlier this month, Detroit had only a 47-day supply of domestic cars on hand at then-current selling rates—well below the 60-65 day level that usually prevails at this time of year. Retail sales in May virtually flattened, while industrial production rose only one-third as fast as in April.

Well-balanced though it is, the current business expansion is approaching a critical stage. Because it wants to keep a lid on inflation and inflation psychology, the Federal Reserve is not fully accommodating all of the demands for money and credit. This is why interest rates have risen from their low points of a year ago and why they are likely to go up further over the balance of this year and into the first few months of 1985. Obviously, too high a level of interest rates will bring this expansion to a halt, producing another recession. Besides its impact on employment, sales and earnings, a new recession practically guarantees a reversal of the dramatic improvement that has occurred in the economics of country debt (Economic Report—April 1984).

The Fed's Dilemma

If the Federal Reserve tries to keep interest rates down by accommodating all of the borrowing needs implied by the demands for funds, then it runs the risk of generating a new round of inflation. And while some might argue that a little inflation might be just the ticket to help solve the country debt crisis plus one or two other problems, I am afraid that if the Central Bank were to adopt this posture, the ensuing round of inflation would not be modest. One could easily envision the rate of inflation going up beyond the peaks reached in 1980 if markets were to believe that the Fed has thrown in the towel and given up the battle against higher prices.

There is a way out, of course. It is for Washington to reduce its budget deficit, thus its claims on the nation's financial resources. No amount of legerdemain by the Administration or its supply side supporters can obfuscate the fact that it is the current and projected budget deficit by the Federal government that threatens to upset this well-balanced recovery. It does not matter what the Administration's beliefs are regarding the connection between its deficits and the level of interest rates, the value of the dollar, inflation psychology, monetary policy and the plight of the borrowing countries. What does matter is what the financial markets believe, for when day is done they prevail. And the markets are deeply concerned about the deficit—witness the high levels of real interest rates. It's time that the Administration recognizes this and gets down to some serious deficit-cutting before it becomes too late to avoid another inflation cycle, recession cycle —or both. H

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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
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and Economist

SEPTEMBER 1984

Who's Right?

During the summer, the Congressional Budget Office (CBO) and the Office of Management and Budget (OMB) released budget projections for the balance of this decade. As you will recall, both agencies projected that the Federal Government's budget will remain in the red through the year 1989—and by a substantial amount. In addition, the estimates of these two agencies varied to a considerable extent.

Given the magnitudes of the numbers projected for Washington's flow of red ink (Table I), the reader would not be blamed for responding to the question posed in the headline of this Report by saying, "who cares?" For either set of numbers means a significant rise in the country's debt burden, thus raising questions regarding the availability of money for the private sector to grow and prosper. However, there is one important difference between the two sets of budget numbers which could have a bearing on the level of interest rates, affecting not only our economy, but foreign economies as well.

The CBO projections show the deficit rising each year starting in 1985, whereas the Administration's outlook is for the deficit to decline, by and large. By 1989, as you can see, there is a gap of $124 billion between the two forecasts. Since it is generally agreed that interest rates are high today relative to inflation because of fears of what these deficits might do to the cost and availability of money, it would follow that a deficit that tends to decline over the years—even if it remains uncomfortably large—might be consistent with some decline in these levels of real interest rates. On the other hand, the reverse might be expected, were the deficit to trend upward.

While the question posed in the headline of this Report cannot be answered definitely until the books are closed on fiscal year 1989 five years from now, it may not be a fruitless exercise to examine these two sets of

TABLE I

ECONOMIC PROJECTIONS
OMB vs. CBO

				Projections									
	1983(a)	1984(e)		1985		1986		1987		1988		1989	
		O*	C*	O	C	O	C	O	C	O	C	O	C
Real GNP Growth (% change, year-over-year)	3.7	7.2	7.3	4.3	3.6	4.0	3.1	4.0	3.3	4.0	3.1	3.9	3.0
Consumer Price Index for Urban Wage Earners & Clerical Workers (% change, year-over-year)	3.0	3.5	3.2	4.6	5.2	4.5	5.0	4.2	4.7	3.9	4.8	3.6	4.8
Unemployment Rate[1] (percent, annual average)	9.5	7.2	7.3	6.6	6.7	6.4	6.6	6.2	6.4	5.9	6.3	5.7	6.3
3-Month Treasury Bill Rate (percent, annual average)	8.6	9.5	10.0	9.3	9.7	8.5	8.9	7.2	8.9	5.9	8.9	5.1	8.9
Wages and Salaries (% change, year-over-year)	5.8	8.7	9.0	7.9	8.4	8.2	7.8	8.5	8.0	8.5	7.7	7.9	7.7
Addendum: Federal Budget Deficit (billions of dollars)	−195	−174	−172	−167	−178	−166	−195	−173	−216	−160	−238	−139	−263

[1]OMB forecasts the total unemployment rate including armed forces, while CBO forecasts the civilian unemployment rate.

*O = Office of Management and Budget C = Congressional Budget Office (a) actual (e) estimate

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budget projections. This is because participants in the business, economic and financial communities must have some idea of what the government is planning so that they can draw up their own plans.

It seems to me that there are four ways of analyzing these projections. One can examine assumptions made regarding legislative policy—that is whatever changes are anticipated in current laws governing taxes or spending. It is also possible to compare the economic assumptions that underlie both sets of projections. Another useful approach is to see if the forecasts are internally consistent. Finally, the track records: How good have these agencies' forecasts been in the past?

Policy Assumptions Differ...

Differing policy assumptions between CBO and OMB account for some of the differences in the projections of the budget deficit as well as in its direction. The CBO estimate assumes no further changes in current laws governing taxes or spending, whereas OMB's mid-session outlook includes policy changes that have been proposed but not yet enacted. These changes are expected to yield close to $37 billion worth of increased revenues over the 1985–89 period, along with nearly $11 billion worth of outlay savings. This alone is responsible for reducing the OMB's five-year deficit projection by $47.5 billion. An additional sum of $17.6 billion is added to reflect the savings in debt service that the Administration thinks will result once the reduced deficit projections come to pass. Interestingly, both OMB and CBO have similar projections for defense outlays. CBO expects national defense expenditures to total $1,654 billion during the 1985–89 period, while OMB projects $1,655 billion.

Adding all this up reduces OMB's budget deficit projected through 1989 by $65 billion. This is slightly more than half of the difference between its projections for 1989 and CBO's. It is, of course, a matter of opinion as to whether or not these policy changes assumed by the Administration on both the revenue and spending side will come to pass. They both depend on the results of the elections—not only whether the President is re-elected, but the makeup of the new Congress and whatever "mandate" can be derived as a by-product.

Of course, differing economic assumptions also account for differences in the two sets of deficit projections. In the main, the Administration assumes faster economic growth, less unemployment, lower interest rates and less inflation than does the Congressional Budget Office. Like policy, assumptions about economic conditions are also a matter of opinion and may or may not come to pass. However, unlike policy assumptions, it is possible to evaluate the economic assumptions based on historical precedent and internal consistency.

...As Do Economic Projections

Both OMB and CBO forecast continued growth through the period; neither expects a recession. While it might be too much, perhaps, to expect either agency to project a recession over such a long horizon, it is important to note what the absence of a projected recession would mean from a historical standpoint. The period between fourth-quarter 1982 and fourth-quarter 1989 is seven years or 28 calendar quarters. Only once in the past 130 years did the economy grow uninterruptedly for such a long period of time. That was, of course, the 106-month expansion that started in February 1961 and lasted until December 1969. The only other expansion that comes even close to it was the 80-month expansion which began in June 1938 and lasted until February 1945. Both expansions, I might add, are considered by the National Bureau of Economic Research to have been wartime expansions. And periods of war, the record shows, tend to lengthen expansions by an average of one year. Since the current period is peacetime in nature, it would be quite an accomplishment if the current expansion lasted 28 calendar quarters: The average postwar peacetime expansion has lasted only 34 months.

As for the rate of growth, the Administration projects that the real GNP will expand by 37.6 percent during the 28 quarters between fourth-quarter 1982 and fourth-quarter 1989. This is larger than any increase posted during the past 35 years with the exception of the 40.5 percent rise recorded during the 1961–69 expansion. It is also 70 percent above the historical average increase in the real GNP during the average expansion. The fact that CBO's projected growth rate was chosen to be consistent with the average growth rate for the seven years following the end of the first six postwar recessions does not make it any more likely to occur.

When one looks at all of the uncertainties out there, one can see why it is appropriate to be skeptical regarding the prospects for a seven-year recovery. Let's start with the present. The walkout on September 15th by the United Auto Workers against General Motors should be a reminder that strikes can and do occur from time to time and if they occur in a major industry such as autos, they could have a depressing effect on economic activity in the aggregate. Indeed, it was a similar walkout in 1970 that hit the economy so hard that the entire year was eventually classified a recession year. While the labor movement has been rather restrained during the past several years, it has been due largely to the recession and its after-effects—not to mention the impact of the strong dollar. Regardless of

TABLE II

INTEREST OUTLAYS AND THE BUDGET DEFICIT

CBO vs. OMB

Year	$ Billions				Interest Outlays as Percent of Budget Deficit		Interest Outlays as Percent of Total Outlays		Interest Outlays as Percent of Personal Income Tax Revenues	
	Interest Outlays		Budget Deficit							
	CBO	OMB	CBO	OMB	CBO	OMB	CBO	OMB	CBO	OMB
1983 (a)	$ 90	$ 90	$195	$195	46%	46%	11%	11%	31%	31%
1984 (e)	111	109	172	174	65	63	13	13	37	37
1985 (p)	134	130	178	167	75	78	14	14	39	38
1986 (p)	150	146	195	166	77	88	15	15	40	39
1987 (p)	169	156	216	173	78	90	15	15	41	38
1988 (p)	194	160	238	160	82	100	16	14	43	35
1989 (p)	214	147	263	139	81	106	16	12	43	30

(a) actual (e) estimate (p) projection

what happens to the dollar, it is not reasonable to assume that labor will remain as subdued in the future (especially during a seven-year boom) the way it was in the past.

The Dollar Is An Uncertainty

With reference to the dollar, the Administration makes no mention of what might happen were the dollar to fall. Given its forecast of declining real interest rates over the period, plus the general feeling that it is today's high level of real interest rates in the U.S. compared with other countries that has boosted the value of the dollar, it is not unreasonable to assume that the dollar might drop over this forecast horizon. The CBO forecast does not deal with the value of the dollar in its longer run projections, but it does explicitly assume that the dollar will remain at its present high level through 1985. It also discusses what might happen in the event of a sharp depreciation in the dollar.

CBO believes that the short-run effect of dollar depreciation would be to temporarily increase the U.S. trade deficit, although within a year or so the trade balance should begin to improve as U.S. goods become more competitively priced abroad and foreign-made goods become more expensive. Depreciation of the dollar would also boost inflation; CBO believes that each 10 percent reduction in the value of the dollar would increase the overall price level by about one percent within two years.

Any further effect on the economy in general and on the financial markets in particular would depend on how the Federal Reserve reacted. If the Fed did not compensate by boosting its monetary growth targets, CBO believes that domestic interest rates would probably rise. Interest rates would also be under upward pressure reflecting the movement out of dollar assets that would lead to a drop in the dollar in the first place.

Besides strikes and changes in the value of the dollar, there are other uncertainties—some of which can be anticipated, while others could come as a surprise. Those that one could think of include a dramatic change in world oil prices (up or down) and the trend towards increased protectionist pressures which at some point could materially reduce world trade and retard economic growth both here and abroad. Also, the weather is a constant uncertainty and could affect prices and supplies of foods.

One of the things that bothers me about both forecasts is what the continued flow of red ink means for Washington's interest expense. As you can see from Table II, CBO projects that by 1989 the Federal Government's annual cost of servicing its debt will amount to $214 billion compared with $90 billion last year. This would equal more than 80 percent of CBO's projected deficit for that year and take approximately one out of every six dollars that the government will budget for spending. By contrast, OMB's projected interest expense is lower ($147 billion)—but as a percentage of the projected deficit it is an astounding 106 percent! One wonders if either scenario could ever come to pass and if either does, what it would mean to the government's ability to *ever* reduce the budget deficit—not to mention to the public's attitudes toward those who hold Treasury securities and who would rightly demand that their interest be paid.

Perhaps there is one ray of hope. The ability of CBO and OMB to forecast the Federal Government's budget deficit is, to put it kindly, poor. Both agencies forecasted in July 1981 that by this year Uncle Sam would enjoy a budget surplus. Maybe both these agencies will make the same kind of forecasting error in the future that they did in the past—hopefully overestimating, rather than underestimating Washington's budget deficit.

Who's right? Neither, I hope.

H

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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
Senior Vice President
and Economist

OCTOBER 1984

Economic Forecast For 1985

The U.S. economy has reached a critical juncture. The business recovery will celebrate its second anniversary next month. By business cycle standards, this takes it out of the stage of youth and puts it more in the category of middle age. This is because in the postwar era, upswings have averaged only 34 months during peacetime periods. And while an average does not necessarily indicate an upper limit to the life of an expansion, it does suggest that, from now on, it will be more susceptible to adverse developments than it was when it was younger and more vigorous.

Another historical point might be worth noting. While business generally does well during a Presidential election year, it tends to suffer in the period immediately following. With only two exceptions, the U.S. has had a recession within 13 months of every Presidential election since 1944. More specific to the current scene, there are a number of economic statistics which are giving off mixed signals.

The Signs Are Favorable...

For a while, it looked like a recession was nigh. The Commerce Department's widely-followed index of leading economic indicators fell in June and again in July. There were widespread expectations that the August reading would show another decline, making it three in a row. While there have been many occasions when a three-month drop in the leading economic indicators was not immediately followed by a recession, every recession that has developed in the postwar era has been preceded by such a three-month decline. Fortunately, this did not occur, but even with August's uptick, this index is about at the same level as it was last January.

There are other signs of softening as well. For one thing, industrial commodities' prices have been dropping sharply since last spring. Such a drop in these commodities' prices is usually associated with an economic decline, not an upswing. Another sensitive indicator of current and future business conditions is the stock market. Notwithstanding the ups and downs of the past few months, the fact remains that equities, as measured by the widely-followed averages, are no higher today than they were a year ago. And even with September's increase, sales of actual merchandise at the retail level are only slightly above levels first reached at the end of 1983.

Not surprisingly, factory output rose only 1/2 percent over the third quarter compared with more than two percent in the second and nearly three percent in the first; September's decline was the first in almost two years. The unemployment rate is no lower today than it was last May after dropping at an average rate of 0.2 percent per month during the previous 20 months. New-home construction is no higher than a year ago, while the annual rate of new car sales hasn't changed very much since January. To top it off, imports are accounting for a rising share of a wide variety of products at the business and consumer level.

Having taken note of all of these factors, it would appear that the pluses still exceed the minuses. As you can see from the GNP table, no recession is expected during the forecast period. I would offer several reasons for this belief. The first stems from an analysis of the push that the economy is getting from fiscal and monetary policies. It should not be forgotten that these do play a key role in shaping business conditions. Fiscal policy, as you might have suspected, is extremely stimulative—what else would it be, in view of the tremendous budget deficits racked up in recent years? However, you might be surprised to learn that monetary policy is stimulative, too. Both fiscal and monetary policy in real (inflation-adjusted) terms are more stimulative during this expansion than they have been in any prior postwar upswing—and by a considerable amount.

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Business is adding thrust as well. According to the Commerce Department's latest survey of corporate spending intentions, capital spending will rise this year, after falling for two consecutive years. This has several favorable implications for the current business expansion. When companies spend more on capital goods, it increases the demands on those industries that produce these goods. This means more employment, more materials and supplies, as well as financial and other services. You can see where this has a ripple effect throughout the economy. Additionally, as new capacity comes onstream, it adds to industry's ability to turn out goods without the shortages and bottlenecks which usually lead to inflation. And by replacing outmoded machinery and equipment with the latest technological developments, it makes U.S. business more efficient, further helping to contain inflation.

. . . For Low Inflation . . .

On the subject of inflation, I cannot help but note that, contrary to the fears expressed by some economists, Wall Streeters and others, inflation has remained tranquil so far in this economic recovery (Economic Report—March, 1984). Twenty-one months into the current expansion finds prices, as measured in the GNP accounts, rising by the smallest percentage for this stage of any recovery since the early 1960s. Producer prices are up only one third as fast as they have been at this point in past business expansions; they have been virtually flat since last spring. The drop in prices of industrial raw materials referred to earlier argues for continued stability at the producer level and very low inflation at the consumer level. As long as inflation remains modest, the expansion will continue, for people's buying power will remain strong and the Federal Reserve will have no reason to tighten.

There are other souces of strength. For one thing, business has maintained a fairly low level of inventories relative to sales. In most industries, inventories are at one of their lowest levels relative to sales in the postwar era, taking out the effects of inflation. With consumer spending rising once again, and the important Holiday shopping season rapidly approaching, you can see where many businesses will be hastily adding stocks—fueling further the pace of economic activity.

In retrospect, it should have been apparent that the summer lull in consumer spending was not likely to last very long. For consumers are in very good psychological and financial shape—factors which show up in the various surveys of consumer buying intentions. Attitudes are positive, thanks to high levels of employment combined with moderate inflation and lower taxes. This is supported by the latest reading of the so-called "misery" index—the combination of inflation and unemployment—which today is half of what it was four years ago and is the lowest since 1973.

Incomes are rising faster than prices and taxes, thanks not only to high employment, but also to high interest rates. As has been pointed out in the past, interest income is now the second largest component of personal incomes and just about the fastest growing. People's interest earnings far exceed their interest expense. The net result of all of this is that consumers' buying power in the aggregate is growing at one of the fastest rates in the past ten years. And if this were not enough, individuals' savings are up and they have room to take on additional debt, if they need to.

With all of these favorable factors in train, it is appropriate to ask the question: What happened during the third quarter? Why did business activity slow as dramatically as it did? In my opinion, this slowing—which, by the way, was long awaited and hoped for by many in the financial community—can be explained by two major factors. The first is that it is not unusual for the pace of business to slow seven quarters into an economic expansion. If one might be permitted the analogy of an aircraft, upon takeoff the ascent is steep; once cruising altitude is reached the plane levels off—but it is still going forward and that is all that matters. If there is anything unusual about the current experience, it's that it took so long for this leveling off to occur. For even with the slower rate of growth in the third quarter, the current expansion is still stronger than it has been at this point in the typical postwar economic upswing. This recovery's second year has so far been stronger than its first—the reverse of the usual cyclical pattern.

Another reason why this slowdown in particular occurred stems from developments in Detroit. As you will recall, the United Auto Workers spent a good part of the summer negotiating a new contract with General Motors. There were widespread fears that these negotiations would not result in a new contract by the time the old one expired and that the UAW would go out on strike. As a consequence, many suppliers to the automobile industry as well as those who sell to these suppliers and to their employees cut back their shipment of goods and stocking of inventories, not wishing to get caught with piles of unsold merchandise. This, quite naturally, depressed sales and output in a broad sector of industry. Additionally, there were shortages of certain popular cars which further constrained spending. I would also not be surprised if the political conventions, the Olympics, a boom in overseas travel reflecting the strong dollar, and some unusually bad weather back in the U.S. kept many people out of stores. Plainly, these factors are now behind us, thus I expect a pickup in growth in the current quarter which will provide a good jumping-off point for 1985.

. . . And More Growth

This jumping-off point is so high that even if the real GNP flattens at fourth-quarter 1984's level, 1985's GNP will still come in about 1-1/2 percent higher than this year's average. But as you can see from the table, we are not expecting such a flattening, although we do believe that growth will be more subdued next year.

The reasons for this slowdown in growth stem from its composition. This year and last were largely powered by the consumer, making up for time lost during the recession of 1981-82 as well as the dip of first-half 1980. Now the torch is being passed to business, and while corporate expenditures should rise at a healthy clip, it will not be enough to offset the slowing expected in the much larger level of consumer spending, as more and more people find that their pent-up demands have been satisfied and/or discover that high interest rates will make it difficult for them to buy housing and other big-ticket items. Job creation, which has already slowed somewhat, will slow some more; this, too, will cut into growth of consumer spending. And of course, a good part of these demands will be met by imported merchandise while the dollar remains strong.

The point to remember is that as long as inflation and inventories remain modest, neither the Federal Reserve nor the private sector will step on the brakes. Thus the current slowdown is unlikely to develop into a recession—at least not yet. H

October, 1984

MHT FORECAST OF GROSS NATIONAL PRODUCT
(Seasonally Adjusted Annual Rates)
In $ Billions

	< Actual			Projected >								
	1984				YEAR 1984		1985				YEAR 1985	
	1	2	3	4	LEVEL	% CH	1	2	3	4	LEVEL	% CH
Gross National Product	3553.3	3644.7	3701.2	3773.0	**3668.1**	**11.0**	3842.1	3886.7	3931.8	3986.6	**3911.8**	**6.6**
GNP: $72	1610.9	1638.8	1649.6	1668.4	**1641.9**	**7.0**	1681.1	1684.9	1688.8	1693.6	**1687.1**	**2.8**
% Change, Annual Rates	10.1	7.1	2.7	4.6	**7.0**		3.1	0.9	0.9	1.1	**2.8**	
Consumption	2276.5	2332.7	2359.3	2409.9	**2344.6**	**8.8**	2452.7	2487.2	2518.3	2552.0	**2502.5**	**6.7**
Durables	310.9	320.7	317.3	330.7	**319.9**	**14.3**	336.6	337.6	337.2	337.6	**337.3**	**5.4**
Non-Durables	841.3	858.3	863.3	874.1	**859.3**	**7.2**	886.3	897.0	907.0	918.1	**902.1**	**5.0**
Services	1124.4	1153.7	1178.7	1205.1	**1165.5**	**8.5**	1229.8	1252.5	1274.2	1296.3	**1263.2**	**8.4**
Investment	623.8	627.0	660.5	655.6	**641.7**	**36.1**	662.3	661.0	663.5	671.9	**664.7**	**3.6**
Non-Residential	398.8	420.8	431.5	451.7	**425.7**	**20.6**	462.0	470.8	478.7	485.7	**474.3**	**11.4**
Producers Durable Equipment	256.7	270.7	279.9	290.1	**274.4**	**22.9**	295.1	299.7	303.8	307.0	**301.4**	**9.8**
Structures	142.2	150.0	151.6	161.5	**151.3**	**16.7**	166.9	171.1	174.9	178.8	**172.9**	**14.3**
Residential	151.2	155.6	156.6	152.6	**154.0**	**16.5**	151.0	149.4	148.8	150.5	**149.9**	**-2.7**
Inventory Changes	73.8	50.6	72.4	51.3	**62.0**		49.2	40.8	36.0	35.7	**40.4**	
Net Exports	-51.5	-58.7	-85.5	-68.7	**-66.1**		-67.0	-71.3	-75.5	-80.1	**-73.5**	
Government Purchases	704.4	743.7	766.9	776.3	**747.8**	**9.1**	794.2	809.8	825.6	842.9	**818.1**	**9.4**
Federal Defense	213.4	220.8	225.4	232.1	**222.9**	**11.2**	239.0	244.1	249.4	257.5	**247.5**	**11.0**
Federal Civilian	54.2	75.6	82.3	79.1	**72.8**	**5.1**	81.3	82.7	83.6	83.1	**82.7**	**13.6**
State & Local	436.8	447.4	459.2	465.1	**452.1**	**8.7**	473.9	483.0	492.5	502.3	**487.9**	**7.9**
Final Sales: $72	1579.3	1618.5	1618.5	1646.9	**1615.8**	**5.0**	1660.7	1668.2	1674.3	1679.4	**1670.7**	**3.4**
% Change, Annual Rates	3.6	10.3	0.0	7.2	**5.0**		3.4	1.8	1.5	1.2	**3.4**	
GNP Price Index (1972 = 100)	220.6	222.4	224.4	226.1	**223.4**	**3.8**	228.6	230.7	232.8	235.4	**231.9**	**3.8**
% Change, Annual Rates	4.4	3.6	3.6	3.1	**3.8**		4.3	3.8	3.8	4.5	**3.8**	
PCE Defiator (1972 = 100)	218.0	219.2	221.6	223.1	**220.5**	**3.2**	225.1	227.2	229.4	231.8	**228.4**	**3.6**
% Change, Annual Rates	3.8	2.2	4.5	2.7	**3.2**		3.7	3.8	3.9	4.3	**3.6**	
Consumer Price Index (1967 = 100)	306.8	309.6	312.5	315.5	**311.1**	**4.3**	318.5	321.6	324.7	328.2	**323.3**	**3.9**
% Change, Annual Rates	5.0	3.7	3.9	3.8	**4.3**		4.0	3.9	3.9	4.3	**3.9**	
Total Personal Income	2920.5	2984.5	3047.7	3089.8	**3010.6**	**9.7**	3145.0	3186.3	3232.3	3288.7	**3213.1**	**6.7**
Disposable Personal Income	2502.2	2554.3	2604.8	2637.9	**2574.8**	**10.0**	2688.9	2722.8	2760.0	2805.5	**2744.3**	**6.6**
Savings Rate	6.1	5.7	6.1	5.5	**5.8**		5.6	5.5	5.6	5.9	**5.7**	
Employment Rate	57.5	58.2	58.1	58.4	**58.0**		58.6	58.7	58.7	58.6	**58.6**	
Unemployment Rate	7.9	7.5	7.4	7.1	**7.5**		7.1	7.2	7.3	7.5	**7.3**	
Indus. Production (1967 = 100)	159.8	163.1	165.7	167.8	**164.1**	**11.2**	169.5	169.7	169.8	169.9	**169.7**	**3.4**
Housing Starts (000)	1968.0	1895.3	1656.3	1659.2	**1794.7**	**5.4**	1632.5	1582.7	1547.8	1590.9	**1588.5**	**-11.5**
Domestic Auto Sales (000)	8162.3	8262.0	8023.4	8220.5	**8167.1**	**20.2**	8609.9	8153.5	7845.8	7455.1	**8016.1**	**-1.8**
Corporate Pre-Tax Profits	243.3	246.0	243.0	247.1	**244.8**	**20.5**	244.3	236.3	228.2	222.7	**232.9**	**-4.9**
– Taxes	92.7	95.8	95.1	99.9	**95.9**		99.6	95.1	90.6	87.5	**93.2**	
Net Profits	150.6	150.2	147.9	147.1	**149.0**	**16.9**	144.7	141.2	137.6	135.2	**139.7**	**-6.2**
– Dividend Payments	77.7	79.9	81.1	82.4	**80.3**	**10.2**	84.2	86.5	89.0	91.3	**87.7**	**9.3**
Undistributed Profits	72.9	70.2	66.9	64.7	**68.7**	**26.0**	60.5	54.7	48.6	43.9	**51.9**	**-24.4**
+ Depreciation	287.5	296.4	306.0	316.6	**301.6**		330.6	340.7	350.8	361.9	**346.0**	
– Inventory Profits	13.5	7.3	4.8	7.8	**8.3**		15.4	16.8	17.4	21.7	**17.8**	
Net Cash Flow	346.9	359.3	368.1	373.6	**362.0**	**17.6**	375.7	378.7	381.9	384.1	**380.1**	**5.0**

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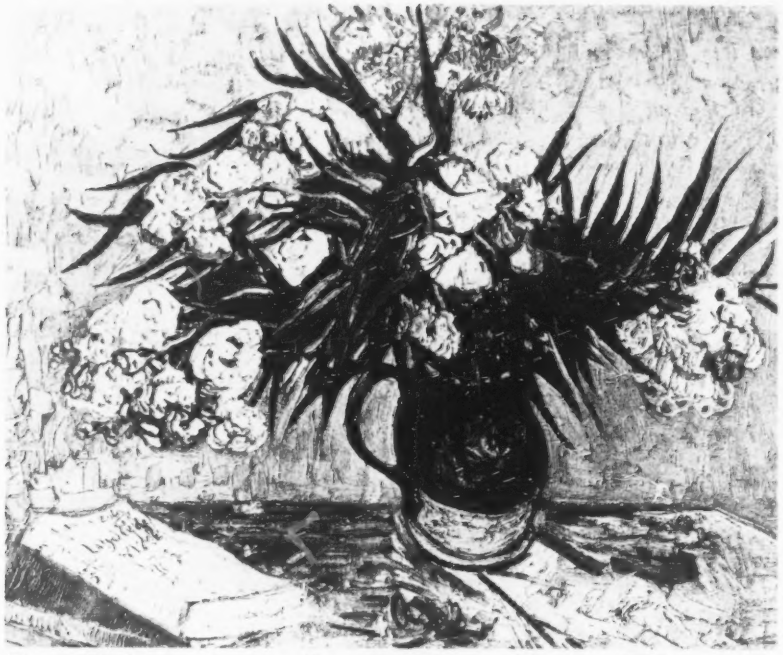

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